Madurai Kamaraj University

(University with Potential for Excellence)

Distance Education

www.mkudde.org



ACL - MK
01125

M.B.A.
SECOND YEAR
IV Semester
Elective II - Finance

INTERNATIONAL TRADE FINANCE AND DOCUMENTATION

MADURAI KAMARAJ UNIVERSITY
MADURAI - 625 021.

S425

Madurai Kamaraj University

(University with Potential for Excellence)

Distance Education

www.mkudde.org

M.B.A.

SECOND YEAR

IV Semester

Elective II - Finance

INTERNATIONAL TRADE FINANCE AND

DOCUMENTATION

MADURAI KAMARAJ UNIVERSITY

MADURAI - 625 021.

S425

Printed At Universal printers
Copies – 500 Reprint 2014

SYLLABUS

1. Foreign Trade and Foreign Trade Transaction

Visible and invisible imports and exports. Balance of Payments. Contract terms. Inco terms. Methods of payments used in Foreign Trade.

2. Shipping documents and Foreign Trade

Various types of: invoice, Insurance Policy, Bill of Lading, Certificate of Origin, Analysis Certificate, Packing List, Weight List etc.

3. Financing foreign Trade

Type of Imports and Exports- Letter of Credits, Foreign Bills of Exchange, Pre-shipment Credit, Packing Credit, Post-shipment Credits, extended by EXIM Bank and others. Advance against Export Incentives, EXIM scripts, Deferred Payment Guarantee.

4. Foreign Exchange

Theories of Foreign Exchange Mechanism. Various Exchange rates. Exchange rate arithmetic. Spot and forward rates. Exchange Control regulations in India. Authorized dealers and their functions. Foreign Exchange Dealers Association of India (FEDAI), Foreign Exchange Regulations Act (FERA), Reserve Bank of India (RBI), Exchange Control Manual.

5. International Exchange Systems

Post Exchange Systems, Present Exchange Systems, Convertibility and inconvertibility, International Monetary Fund. Special Drawing Rights. Devaluation and Revaluation.

6. International Financial Institutions

EXIM Bank, International Monetary Fund (IMF), Asian Development Bank (ADB), Export Credit Guarantee Corporation (ECGC), World Bank, International Development Association, Bank for International Settlement, Multilateral Investment Guarantee Agency, International Investment Bank, Industrial Credit and Investment Corporation of India (ICICI).

7. International Exchange System

Brettonwood System-Free float of currencies-LERMA-Interest Rates vs. Exchange Rates-SDR-Devaluation and Revaluation-Central Bank's role.

CONTENTS

UNIT - I

INTRODUCTION **1**

UNIT - II

METHODS OF PAYMENTS USED IN FOREIGN TRADE **32**

UNIT – III

TYPES OF LETTER OF CREDIT **47**

UNIT - IV

PRE-SHIPMENT AND POST-SHIPMENT CREDIT **80**

UNIT - V

THEORIES OF FOREIGN EXCHANGE **98**

UNIT - VI

EXCAHNGE CONTROL IN INDIA **143**

UNIT - VII

INTERNATIONAL FINANCIAL INSTITUTIONS **171**

UNIT - VIII

ROLE OF INTERNATIONAL FINANCIAL INSTITUTION **208**

UNIT - IX

THEORIES OF INTERNATIONAL TRADE **280**

UNIT - X

INTERNATIONAL TRADE FINANCE IN INDIA **326**

INTRODUCTION

International trade plays a very important role in the economic development and sustenance of most of the nations, The fact that international trade grows much faster than the world output implies that for many a dynamic enterprise, the potential market is not confined to the national frontiers, And for a good number of companies the overseas market is not a secondary market but the primary market, The large and expanding world market often offers greater growth and profit opportunities than the domestic market. No wonder, the multinational enterprises have been growing fantastically and dominate many sectors of the international market. For many small and medium size enterprises too the overseas market is very important.

International market involves various types of trade documents that need to be produced while making transactions. Each trade document is differ from other and present the various aspects of the trade like description, quality, number, transportation medium, indemnity, inspection and so on. So, it becomes important for the importers and exporters to make sure that their documents support the guidelines as per international trade transactions. A small mistake could prove costly for any of the parties.

This material is intended to provide the various theoretical aspects of International trade finance and documentation. This book is divided into ten units which cover the whole aspects of International trade finance and documentation.

UNIT-1

INTRODUCTION

NOTES

1.1. Introduction

1.2 Unit Objective

1.3. Visible, Imports and Exports

1.3.1 Invisible Imports and Exports

1.3.2 Balance of Payments

1.4 Adjustment of Demand and Supply of Foreign Currency

1.5 INCOTERMS

1.6 Summary

1.7 Keywords used in the lesson

1.8 Answer to check your progress questions

1.9 Model Questions

1.10 Further reading

1.1 INTRODUCTION:

This unit covers the general outline about Visible and invisible imports and exports, Balance of payment and its importance and limitations of BOP statement. Also, it dealt with what are International commercial terms used in International trade. We can have the sound knowledge if we are familiar with this unit.

Meaning of International Trade

International trade

International trade is the exchange of raw materials, goods and services across the geographical borders of countries across the globe. Foreign trade got its first impetus from the industrial revolution in the late eighteenth and early nineteenth century. Rapid

development in transportation facilities resulted in a surge in international trade in the twentieth century. Today International trade has taken the form of outsourcing and multinational companies (companies that have a presence in several countries).

NOTES

The History of World Trade

World trade was prevalent much before the formation of nation states. Some important examples of ancient long distance trade are:

The Egyptians imported spices from Arabia and the „Land of Punt" (present day Somalia).

The Ptolemaic dynasty, which ruled in Egypt from 305 BC to 30 BC, traded with India.

Arabian vessels were used to transport Indian goods to Aden. Chinese goods made their way to India, Persia and Rome through the silk route. From the eighteenth century, industrialization and colonization went hand in hand. The European nations increased their political power through trade. They exploited trading opportunities in eastern countries like India.

Present Global Trade Scenario

There was a dramatic rise in world trade volumes in the twentieth century. While in 1928, world exports amounted to US$31.7 billion, this figure had risen to US$4,215,000.2 billion by 1994. Studies conducted by the UNCTAD in 1994 show that trade in commercial services rose much faster than merchandise trade between 1970 and 1990.

The G-7 group, comprising of the US, France, Germany, the UK, Italy, Japan and Canada, has always commanded a dominant position in world trade. Gradually the significance of certain Asia Pacific nations, such as China, Singapore, India, Hong Kong, Taiwan and Korea, has risen.

1.2 OBJECTIVE:

to gain knowledge in the field of balance of payment

to become familiar with international commercial terms

to know the methods of payment used in foreign trade

NOTES

1.3. VISIBLE IMPORTS AND EXPORTS

The Current Account is a record of the trade in goods and services among countries. The trade in goods is composed of exports (selling merchandize to foreigners) and import (buying merchandize from abroad). Exports are a source of funds and result in a decrease in real assets. On the other hand, imports are a use of funds and result in an acquisition of real assets **(visible).**

Check Your Progerss

1. Imports lead to increase in value of real asset, so, it may be called as _____.

1.3.1 Invisible Imports and Exports

The trade in services **(also called invisibles)** includes interest, dividends, tourism/travel expenses and financial charges, etc. Interest and dividends measure the services that the country"s capital renders abroad. Payments coming from tourists measure the services that the country"s shops and hotels provide to foreigners who visit the country. Financial, instance and shipping charges measure the services that the country"s financial and shipping sectors render to foreigners. Receipts obtained by servicing foreigners on these counts constitute source of funds. On the other hand, when the country"s residents receive the service from foreign-owned assets, utilization of founds, takes place.

Unilateral transfers consist of remittances by migrants to their kith and kin, and gifts. Donations and subsidies received from abroad. Remittances so received are obviously sources; remittances made in forms of gifts/donations, etc., by immigrants cause utilization of funds.

1.3.2 Balance of Payments

Balance of Payments (BOP) records commercial, financial and economic flows between the residents of a given country and those of the rest of the world during a certain period of time, generally a year. It measures flows rather than stock.

In the context of BOP, the resident of a country means any individual, business organization, government agency or any other institution legally domiciled in the country concerned; it does not necessarily mean a citizen. For example, transactions with subsidiary of a French company established in India form part of the records of BOP; transactions between only local residents are outside its purview. However, the exception occurs when a transaction involves a foreign currency that is exchanged between a private resident of the country and its monetary authority or the central bank. Even thought both parties are residents of the same country, this transaction gets reflected in the balance of payments as offsetting entries in two different accounts, namely private capital flows and official reserves.

A BOP statement is kept in the form of sources (credits) and uses (debits) of funds. This record enables us to know whether the country has/had a net surplus or deficit during the referred period. If a country receives more funds from abroad than it spends, it has a surplus of BOP. If expenditures abroad by residents exceed what the residents earn or receive from abroad, the country has a deficit of BOP.

Check Your Progerss

2 Balance of payment is the difference between _____ and _____ of funds.

From the 17th century, countries like France and Germany had prepared the accounts of their exports and imports know as Balance of Trade. Subsequently, the concept has been broadened to include exchange of services, donations as well as flows of capital; this concept of record has been referred to as balance of payments.

The major sources of funds for a country accrued from:

exports of goods and services;

sale of existing foreign financial assets;

Foreign loans/borrowings, etc.

Likewise, the major uses are:

Imports of good and services;

Purchase of foreign financial assets;

Foreign lending"s and so on.

Obviously, sources increase the external purchasing power of country; conversely uses decrease its purchasing power.

1.3.3.1 Presentation of Balance of Payments.

A BOP statement is divided into several intermediate accounts. The three major segments are: (i) Current account, (ii) Capital account, and (iii) Official reserves account. Table 1 provides details of these accounts as shown in a typical BOP statement.

The data needed to prepare different accounts are collected from various sources. For instance, the data on imports and exports are gathered from customs authorities whereas the financing of these transactions appears largely among the data on changes in foreign assets and liabilities reported by financial institutions. That is why there is an additional account in the BOP Statement, namely Errors and Omissions.

The succeeding paragraphs contain a brief description of various accounts shown in the BOP Statement.

1.3.3.2 Current Account: The **current account** is one of the two primary components of the balance of payments, the other being the Capital account. The *current account* is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as interest and dividends) and net transfer payments (such as foreign aid). The current account balance is one of two major measures of the nature of a country's foreign trade (the other being the net capital outflow). A current account surplus increases a country's net foreign assets by the corresponding amount, and a current account deficit does the reverse. Both government and private payments are included in the calculation.

NOTES

It is called the current account because goods and services are generally consumed in the current period.

The balance of trade is the difference between a nation's exports of goods and services and its imports of goods and services, if all financial transfers, investments and other components are ignored. A nation is said to have a trade deficit if it is importing more than it exports.

Positive net sales abroad generally contribute to a *current account surplus*; negative net sales abroad generally contribute to a *current account deficit*. Because exports generate positive net sales, and because the trade balance is typically the largest component of the current account, a current account surplus is usually associated with positive net exports. This however is not always the case with open economies such as that of Australia featuring an income deficit larger than its trade deficit

The net factor income or income account, a sub-account of the current account, is usually presented under the headings *income payments* as outflows, and *income receipts* as inflows. Income refers not only to the money received from investments made abroad (note: investments are recorded in the capital account but income from investments is recorded in the current account) but also to the money sent by individuals working abroad, known as remittances, to their families back home. If the income account is negative, the country is paying more than it is taking in interest, dividends, etc.

For example, the United States' net income has been declining exponentially since it has allowed the dollar's price relative to other currencies to be determined by the market to a point where income payments and receipts are roughly equal. The difference between Canada's income payments and receipts have been declining exponentially as well since its central bank in 1998 began its strict policy not to intervene in the Canadian Dollar's foreign exchange.

The various subcategories in the income account are linked to specific respective subcategories in the capital account, as income is often composed of factor payments from the ownership of capital (assets) or the negative capital (debts) abroad. From the

capital account, economists and central banks determine implied rates of return on the different types of capital. The United States, for example, gleans a substantially larger rate of return from foreign capital than foreigners do from owning United States capital.

In the traditional accounting of balance of payments, the current account equals the change in net foreign assets. A current account deficit implies a paralleled reduction of the net foreign assets.

Current account = changes in net foreign assets

Check Your Progerss

3 _____ account is the sum of balance of trade net factor income and net transfer payments.

1.3.3.3 Capital Account

The Capital Account is divided into foreign direct into foreign direct investment (FDI), portfolio investment and private short-term capital flows. FDIs are for relatively longer period of time and portfolio investments have a maturity of more than one year when they are made. The distinction between FDI and portfolio investment is made on the basis of the degree of involvement in the management of the company (and not on the basis of the extent of ownership) in which investment is made. For example, an ownership of more than 10 percent of a firm may require direct involvement in the firm"s management. In the event of the investor exercising/participate, the investment is then referred to as portfolio investment.

Table I

A) Current Accounts

Goods Account

Exports (+)

Imports (-)

Balance of Goods Account=A (I)

Services Account

Receipts as interest and dividends, tourism receipts for travel and financial changes (+) Payments as interest and dividends, tourism payments for travel and financial charges (-)

NOTES

Balance of Services Account (II)

Unilateral Transfers

Gifts, donations, subsidies received from foreigners (+)

Gifts, donations, subsidies made to foreigners (-)

Balance of Unilateral Transfer Account= A (III)

Current Account Balance: A (I)+A(II)+A(III)

B. Long-term Capital Account

Foreign Direct Investment (FDI)

Direct investment by foreigners (+)

Direct investment abroad (-)

Balance on Direct Foreign Investment=B (I)

Portfolio Investment

Foreigner"s investment in the securities of the country (+)

Investment in securities abroad (-)

Balance on Portfolio Investment=B (II)

Balance on Long-term Capital Account=B (I) +B (II)

Private Short-term Capital Flows

Foreigner"s claim on the country (+)

Short-term claim on foreigners (I)

Balance on Short-term Private Capital Account=B (III)

Overall Balance: [A(I)+A(II)+A(III)+[B(I)+B(II)+B(III)]

C. Official Reserves Account

Decrease or increase in foreign exchange reserves.

As regards official reserves accounts, the monetary authority of a country, usually the central bank, owns international reserves. These reserves are composed of gold, convertible currencies like US Dollar, Deutsch Mark, Japanese Yen, SDR (Special Drawing Rights), etc. since BOP is expressed in national currency, an increase in any of these assets means a use of funds while their decrease implies a source of funds.

If overall balance (current plus capital) is in deficit, this implies either a reduction in reserves or an increase in foreign debt or reduction of credits. It is important to note that, by convention, a deficit is shown by + sign. In other words, it appears on the sources side. As a result, sum of all sources and uses becomes equal. The reverse is true when the overall balance (i.e., the sum of current and capital account) is in surplus.

Example

You are required to find out the overall balance, showing clearly all the sub-balances from the following data:

1. UC Corporation of the USA invests in India Rs.3, 00,000 to modernize its Indian subsidiary.
2. A tourist from Egypt buys souvenirs worth RS.3,000 to carry with him. He also pays hotel and travel bills of Rs.5,000 to Delhi Tourist Agency.
3. The Indian subsidiary of UC Corporation remits, as usual, Rs.5,000 as dividends to its parent company in the USA.
4. This Indian subsidiary of UC Corporation sells a part of its production in other Asian countries for Rs.1,00,000.
5. The Indian subsidiary borrows a sum of Rs.2,00,000 (to be paid back in a year"s time) from the German money market to resolve its urgent liquidity problem.
6. An Indian company buys a machine for Rs.1,00,000 from Japan and 60 percent payment is made immediately; the remaining amount is to be paid after 3 years.
7. An Indian subsidiary of a French Company borrows Rs.50,000 from the Indian public to invest in its modernization programmed.

NOTES

Solution

Sources and Used of Found

SI. NO	Sources	Uses	Native
1	3,00,000		Direct Foreign Investment
2. (a)	3,000		Goods exported
(b)	5,000		Services (invisible) rendered
3.		5,000	Dividends paid
4.	1,00,000		Goods exported
5.	2,00,000		Short-term borrowing
6. (a)			Equipment imported
(b)	40,000	1,00,000	Increase in claim on India (portfolio)
	6,48,000	1,05,000	

BOP Statement

A. Current Account

Goods Account

Export	:	Rs.	1, 03,000 (+)
Import	:	Rs.	1, 00,000 (-)
Balance	:	Rs.	3,000(+)

Invisible Account

Payment Received:		Rs.	5,000 (+)
Payment Made	:	Rs.	5,000 (-)

Balance : Nil

Current Account Balance: Rs. 3000 (+)

B. Capital Account

Foreign Direct Investment

Inflow : Rs. 3, 00,000 (+)

Outflow : Rs Nil

Balance : Rs. 3, 00,000 (+)

Portfolio Investment

Inflow : Rs. 40,000 (+)

Outflow : Rs. Nil

Balance : Rs. 40,000 (+)

Long-term Capital Account: Rs. 3, 40,000 (+)

(FDI + Portfolio)

Short - time Capital

Inflow : Rs. 2, 00,000 (+)

Outflow : Rs. Nil

Balance : Rs. 2, 00,000 (+)

Capital Account Balance: Rs. 5, 40,000 (+)

Overall Balance : Rs. 5, 43,000 (+)

There is a net surplus of Rs.5, 43,000 in the balance of payments. This means, there will be an increase of reserves by this amount.

NOTES

Note: The transaction No.7 did not enter into the BOP Statement since this transaction does not involve any foreign country. The entire transaction has taken place in Indian rupees within India.

1.3.3.4 Importance of BOP

Several reasons explain the importance of Bop of a country for managers and investors.

This permits a judgment on the economic and financial situation of a country in the short-term. If a country has significant deficit, it will have a tendency to take stiff measures for diminishing its imports. Prices of imported materials may go up. In certain countries, a large deficit of BOP may lead to measures of exchange control, or restriction on repatriation of dividends, interests, etc.,

BOP provides foresight regarding the type of exchange rates (increase/decrease) to prevail; consistent deficit of BOP has an unfavorable effect on exchange rate.

In a system of fixed exchange rates, persistent deficit leads to devaluation and vice versa. Likewise, in a system of floating rates, persistent deficit would signal an ongoing depreciation of the currency of the country concerned.

1.3.3.5 Limitations of BOP Statement

BOP is an important source of information on economic and financial situation of a country. The analysis of different accounts in a BOP Statement, interest, enables one to understand or foresee the circumstantial or structural equilibrium.

Sources of information used to prepare a BOP Statement are varied, namely, central bank, institutions linked with external trade such as Export-Import (EXIM) Bank, and customs authorities, etc. A perfect coherence among these sources may not be possible. Thus, the account Errors and Omission serves to bring about equilibrium between economic operation and their monetary counterparts.

BOP Statement is established in terms of transactions. That is, it takes into account transactions rather than settlements. But the dates of effective settlements may be far distant in time from the dates of delivery owing to advances accorded, commercial credits, delay in payments or non-payments, etc.

BOP is expressed in national currency. But often the operations have been done in other currencies. This causes the problem of exchange gain or loss, which is ignored. Some countries like Japan prepare the BOP Statement in two currencies, Yen and US dollar.

Check Your Progerss

4 The difference between Export and Import is called as_____.

1.4 ADJUSTMENT OF DEMAND AND SUPPLY OF FOREIGN CURRENCY

Adjustments between demand for and supply of foreign currency take place through the intervention of central bank, or market, or by administrative measures.

Central bank intervenes through its regulatory stocks. This exercise is necessitated to control the volatility of exchange rate as and when it anticipates a surplus over demand (surplus of the BOP) or vice versa. For example, if a deficit is anticipated, the central bank will offer foreign currency that is holds in reserve. In 1995, RBI sold huge amount of dollars to decrease the significant increase in dollar value.

Adjustment by the market takes place when there is no intervention of central bank. For example, if there is a surplus in the Bop, the national currency tends to appreciate. Conversely, it will depreciate in the event of deficiency. It will float to find the rate of equilibrium.

Administrative measures can be taken on the demand and supply of the currency. To diminish the outflow of foreign exchange, the concerned country can take measures such as, increase in customs duty, fixing of import quotas, obligatory deposits for imports, protectionist measures, prohibition on short-term placements, control on speculative movements on capital, etc.

In order to increase supply of foreign exchange, the country may imitate measures such as export subsidies, export credits, encouragement for FDI, etc.

In general, surplus BOP is considered good, and deficit Bop as bad. Mostly, when we talk of the problem of BOP, it is the deficit (specially a chronic deficit) that is of deep concern and the country has to tale appropriate measures to tide over the problem, for example, check on imports, import substitution, export promotion measures, borrowing from the IMF, etc.

1.4.1 The link between the national economy and international activities

This section provides a framework consisting of a set of basic macro-economic accounting identities that link domestic production and spending to saving, consumption and investment behaviour and their relationship with current account and capital account balances.

Domestic Savings, Investment and the Capital Account

The national income (or product) is the sum of consumption and savings, that is:

National Income = Consumption + Saving (2.1)

Similarly, national spending consists of consumption and investment:

National Spending = Consumption + Investment (2.2)

From Eqs (2.2) and (2.2), we obtain:

National Income – National Spending = Saving – Investment (2.3)

This identity says if a national"s income exceeds its spending, then, savings will exceed domestic investment, yielding surplus capital. This surplus capital must be invested overseas. In other words, a nation that produces more than it spends, will save more than it invests domestically and will have a net capital outflow. This capital outflow will appear as combination of capital account deficit and an increase in official reserves. Conversely, a nation that spends more than it produces will invest domestically more than it saves and have net capital inflow. This capital inflow will appear as combination of capital account surplus and a reduction in official reserves.

1.4.2 Link between the Current and Capital Accounts

Beginning again with national product, we can subtract from it spending on domestic goods and services. The remaining goods and services must equal exports. Similarly, if we subtract spending on domestic goods and services from total expenditures, the remaining spending must be on imports. This leads to:

National Income – National Spending = Exports – Imports (2.4)

Equation 2.4 indicates that a current account surplus arises when national output exceeds domestic expenditure. Similarly, a current account deficit is due to domestic expenditure exceeding domestic output. By combining Esq.(2.3) and (2.4), we get:

Saving – Investment = Export – Imports (2.5)

As is clear from the Esq. (2.5), if a nation"s savings exceed its investment, then that nation will run a current surplus. Conversely, a nation such as the United States that saves less than it invests must run a current account deficit. Noting that saving minus investment equals net foreign investment, we have the following identity:

Net foreign investment = Export – Imports (2.6)

(Capital outflow)

Thus, the balance on the current account must equal the net capital outflow. If the current account is in surplus, then the country must be a net exporter of capital; a current account deficit indicates that the nation is a net capital importer. This equation explains why Japan with its current account surplus, is a major capital exporter, while the United States, with its large current account deficits, is a major capital importer.

Another interpretation of Esq.(2.6) is that the excess of goods and services bought over goods and services produced domestically must be acquired through foreign trade and must be financed by an equal amount of borrowing from abroad (that is, capital account surplus and/or official reserves deficit). Thus, with the government intervention

NOTES

in the foreign exchange market, the sum of the current account balance plus the capital account balance plus the balance on official reserves account must be zero.

1.4.3 Government Budget Deficit and Current Account Deficits

National spending can be divided into house hold spending plus private investment plus Government spending. Household spending, in turn, equals national income less the sum of private savings and taxes. Combining these terms yields the following identity:

National Spending = Household Spending + Private Investment = Govt. Spending

= (National Income – Private Saving – Takes) + Private

Investment + Govt. Spending (2.7)

Equation 2.7 can be re-arranged to yield a new expression for excess spending: National Spending – National Income = Private investment – Private Saving +

Govt. Budget Deficit (2.8)

Here, the Government budget deficit equals government spending minus taxes.

Combining and re-arranging Eqs (2.4) and (2.8), results in new identity:

Current account balance = saving Surplus – Govt. Budget Deficit

Equation 2.9 reveals that nation"s current account balance is identically equal to its private savings-investment balance less the government budget deficit. That is, a nation running a current account deficit is not saving enough to finances its private investment and government budget deficit. Conversely, a nation running a current account surplus is saving more than is needed to finance its private investment and government deficit.

NOTES

1.4.4 Balance of indebtedness

Apart from BOP, it is desired to have a balance of indebtedness which measures the assets and liabilities that a country has in relation to the rest of the world. This statement is not available in standard published from for all countries, though it would be desirable to do so.

1.5 INCOTERMS (International Commercial Terms)

A trade contract imposes certain rights and obligations on the buyer and seller, these right and obligations varying in accordance with the convenience of the parties concerned and as agreed by them. Certain specific terms have been evolved, known as „trade terms" or „contract terms" such as Free on Board (FOB), Cost, Insurance and Freight (CIF), each of which carries a specific set of rights and obligations between the parties. While quoting the price, the seller takes into account not only the cost of productions but also additional costs and risks involved as per the trade terms agreed. For instance, the price quoted for a consignment of CIF basis will be higher than that on FOB basis as the former requires insurance and freight changes to be incurred additionally.

The existence of difference in interpretation of trade terms in different countries has been a cause of friction in international trade on misunderstanding, disputes and references to courts with all the waste of time and money. The Inco terms (International Commercial Terms) were evolved by the international Chamber of Commerce to provide a set of international rules for the interpretation of the chief terms used in foreign trade contracts. Inco terms were published first in 1936 and subsequently amended and added to in 1953, 1967, 1976, 1980, and 1990. The latest 1990 version defines 13 contract terms, providing an up-to-date set of rules broadly in the line with the current international trade practices.

It may be noted that adoption of Inco terms is optional. Merchants wishing to use these rules should specify that their contracts will be governed by „Inco terms 1990".

Further, special provision in the individual contract between the parties will override anything provided in the rules.

NOTES

The Terms

Arranged in the ascending order of obligations to the seller the contract terms defined are as under:

1.5.1 Contract Terms – Standard abbreviation

Ex Works

Free Carrier Carriage Unpaid

Free Alongside Ship

Free On Board

Cost and Freight

Cost, Insurance and Freight

Carriage Paid to

Carriage and Insurance Paid to

Delivered at Frontier

Delivered Ex Ship]

Delivered Ex Quay

Delivered Duty Unpaid

Delivered Duty Paid

EXW

FCA

FAS

FPN

CFR

CIF

CPT

CIP

DAF

DES

DEQ

DDU

DDP

According to the mode of transport for which they are used, the contract terms may be classified as follows:

Sea and Inland waterway	All modes including multimodal
1. Free Alongside Ship	1. Ex Works
2. Cost and Freight	2. Carriage Paid to
3. Cost and Freight	3. Carriage Paid to
4. Cost, Insurance and Freight	4. Carriage and Insurance Paid to
5. Delivered Ex Ship	5. Delivered at Frontier
6. Delivered Ex Quay	6. Delivered Duty Unpaid
7. Delivered Duty paid	

The main reason for the 1990 revision of the Inco terms was the desire to adapt terms to the increasing use of electronic data interchange (EDI). In all the contract terms where the seller has to send a transport document to the buyer, it is provided that when the seller and buyer have agreed to communicate electronically, the transport document may be replaced by an equivalent EDI message.

1.5.2 Contract Terms for Carriage by Sea Transport

NOTES

FAS – Free Along side Ship (named port of shipment)

The price quote under this contract includes charges up to placing the goods alongside the ship in the seller"s country. The seller"s obligation is to bring the goods to the named port and place them alongside the ship on the quay or the lighters. The buyer has to bear all costs and risks of loss of or damage to the goods from that moment.

The buyer has to contract the sea carrier and arrange for the transportation. He should intimate the seller about the name and loading berth of the ship and the delivery dates. The seller has to tender to the buyer dock or warehouse receipt or warrant which evidences the delivery of goods alongside the ship. He has to bear the cost of any checking operations such as checking quality, measuring, weighing, and counting which are necessary for delivering the goods alongside the ship. The buyer should arrange for the transportation, including obtaining an export license, where it is required.

Check Your Progerss

5 The FAS stands for _____.

6. The FOB stands for _____.

The seller may arrange for booking the cargo with the shipping company and obtain a bill of lading. In such cases, the cost should be borne by the buyer. The seller may also provide at the buyer"s request and the certificate of origin and any other documents that the latter may require.

Documents

The documents that the seller has to submit to the buyer are:

Dock or Warehouse Receipt of Warrant,

Invoice, and

Any other document as required by the buyer.

FOB – Free on Board (named port of shipment)

The price quoted under this contract charges up to preparation of goods for export and placing them on board of the named vessel in the seller"s country. The buyer should arrange for the space in the vessel and intimate the seller so that the latter may arrange to

take the goods to the port at the appropriate time and get them placed on the vessel. The right in the goods passes on to the importer the moment goods are placed on the vessel as per his instructions and hence any loss of or damage to the goods after this stage should be borne entirely by the buyer. The buyer has to pay freight at destination and arrange for insurance covering the journey. As regards the loading charges at the port in the seller"s country, the seller has to bear to the extent they are not included in the freight.

The seller"s duty is to arrange to prepare the goods, pack them, place them on the vessel as per the terms of the contract and obtain a bill of lading evidencing shipment. He has to bear the cost of any checking operation like checking quality, measuring, etc., which may be necessary for delivering the goods. He has to obtain export license and pay export taxes and fees that may be required. If the buyer requests, he has to provide a certificate of origin, the cost of which has to be borne by the buyer. Further, he may assist the buyer at buyer"s risk and expense, in other matters relating to the contract.

The term FOB is normally followed by the name of a port in the seller"s country. For example and Indian seller may quote FOB Chennai. It means the price quoted is for delivery of goods at Chennai port. If no port is mentioned in the terms, the buyer has the right to ask for shipment at any port in India. Therefore, he may require the seller to ship from Mumbai, which may mean additional cost to the seller.

Documents to be submitted under FOB contract are:

Freight paid to collect bill of lading.

Invoice, and

Other documents as required by the buyer.

CFR – Cost and Freight (named port of destination)

The price quoted under this contract includes the cost of the goods and freight charges up to the named destination. The means, the contract term should indicate the port of discharge up to which the freight is included. For instance, for delivery at New York the contract terms should be CFR New York.

The seller has to prepare, pack, transport up to the port and arrange to place the goods on board a vessel and obtain clean freight paid bill of lading. The obligation of arranging the contract of carriage rest with the seller. He has to pay for checking operations any pay unloading charges to the extent they are included in the freight. He has to obtain export license and carry out all formalities necessary for the exportation of the goods. He may furnish the certificate of origin, consular invoice and any other document at the cost and request of the buyer.

Though under CFR contract the seller pays charges up to the destination, the risk of loss of or damage to the goods passes to the buyer the moment the goods are placed on board the ship in the seller"s country. Thus the seller bears the cost up to the destination, but the buyer acquires the interest in the goods from the time they are loaded on board on board a ship in the seller"s country.

Documents to be furnished under this contract are:

Freight paid to bill of lading.

Invoice, and

Other documents as required by the importer.

CIF – Cost, Insurance and Freight (named port of destination)

The price quoted under this contract includes cost of goods, freight charges up to named destination and insurance covering the voyage. In other words, all expenses incurred up to the port of destination are borne by the seller. Unless otherwise specified in the contract, insurance for 110% of contract price with minimum cover of the Institute Cargo clauses shall be obtained. In other respects the duties of the seller and buyer are similar to that under CFR contact. Similarly, the risk in the goods passes on to the buyer the moment they are placed on board a vessel in the seller"s country.

Documents to be furnished under this contract are:

Freight to paid bill of lading,

NOTES

Insurance policy,

Invoice, and

Other documents as required by the buyer.

Variants of CIF Contract

There are two variants of CIF contract in use. They are, however, not recognized under Inco terms:

Cost, Insurance, Freight and Commission (CIF&C). This is similar to CIF contract except that the price includes in addition commission payable to agents for the contract.

Documents

Freight paid to bill of lading.

Insurance policy,

Statement of commission paid,

Invoice, and

Other documents as required by the buyer.

Cost Insurance, Freight Commission and Interest (CIF & C). In addition to the price under CIF contract, this includes commission payable to agents and interest of the transaction.

Documents

Freight paid to bill of lading.

Insurance policy,

Statement of commission paid,

NOTES

Invoice, with details of interest, and

Other documents as required by the buyer.

DES – deliver Ex Ship (named port of destination)

The price quoted includes all expenses up of goods by ship to the named destination. Thus the price quoted may be same as the price under CIF contract. But the essential difference between Ex Ship contract and other contracts discussed above is the time at which the risk for loss of or damage to the goods is passed to the buyer. The responsibility, under the Ex Ship contract, of the seller is to make available to the buyer the goods at the named destination. Therefore, the risk is borne by the seller till the goods are carried to the port of destination. The risk is transferred to the buyer from the time he takes delivery of the goods. In other respects, the duties of the seller and the buyer are similar to those under the CIF contract.

Documents to be submitted under Ex Ship contract are:

Freight paid to bill of lading.

Invoice,

Insurance policy, and

Other documents as required by the buyer.

DEQ – Delivered Ex Quay (Duty paid) (named port destination)

This is effect of an extension of the Ex Ship contract. The seller has to bear the additional risks and cost to bring the goods ashore and make them available to the buyer on the wharf at the destination named in the sale contract. All teat is necessary to enable the buyer to take delivery of the goods at the destination is to be done by the seller. That means, he has to prepare the goods, pack them, arrange for checking operations, transport and insure them. In addition, he has to provide the import duty, cost of customer clearance and any other taxes to be paid on imports for the goods to be delivered to the

buyer. The buyer"s duty is to take delivery of the goods from the quay or wharf at the port of destination. The risk of loss or damage to the goods is passed to the importer then the time the goods are placed the quay. If the parties desire that the import duty, etc., in the buyer"s country should be borne by the buyer, they should specifically mention Ex Quay (duties on buyer"s account).

Documents to be submitted by the seller

Delivery order,

Invoice, and

Other documents as required by buyer.

1.5.3 Contract Terms for Carriage by any Mode of Transport

EXW – Ex works (named place)

The price under this contract represents the minimum since the goods are delivered at the seller"s premises. The price excludes all other expenses. The obligation of the seller is to make the goods available at his premises, i.e., works of factory.

The seller should bear all coats and risks in packing the goods, arranging for checking operations like checking quantity, measurements, weighing and counting, that may be necessary for the purpose of placing the goods at the disposal of the buyer. He should give reasonable notice to the buyer so desires and at his risk, the seller may render assistance in getting documents that may be required for exportation and/or importation of the goods. The seller is not responsible for loading the goods on vehicle provided by the buyer, unless otherwise agrees.

The buyer has to bear the cost and risk involved in bringing the goods from the seller"s works to the desired destination. All costs, taxes, etc., both at the seller"s and the buyer"s country have to borne by the buyer.

NOTES

Documents

Invoice, and

Other documents as required by the buyer,

FCA – Free Carrier (named place)

This term corresponds to FOB under sea transport. The seller fulfils his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier named by the buyer at the named place or point. If no precise point is indicated by the buyer, the seller may choose within the place or range stipulated where the carrier shall take the goods into his charge.

„Carrier" means any person who, in a contract of carriage, undertakes to perform or to procure the performance of carriage by rail, road, sea, air, inland waterway or by a combination of such modes. If may buyer instructs the seller to deliver the cargo to a person, e.g., a freight forwarder who is not a carrier, the seller is deemed to have fulfilled his obligation to deliver the goods when they are in custody of that person.

Except for the mode of transport and place of delivery, the respective positions of seller and buyer are similar to that under FOB contract.

Documents required are:

A transport document,

Invoice, and

Other documents as required by the buyer.

CPT – Carriage paid to (named place of destination)

The contract term can be compared to the CFR term used for carriage by sea transport. The price quoted includes cost of goods and fright charges.

The seller has to prepare the goods, pack them, pay for checking operation and take them for transportation to the carrier. If there are more than one carrier, the seller"s obligation is fulfilled when he delivers goods to the fires carrier. The risk for loss of or damage to the goods passes to the buyer when they are delivered to the first carrier. The formalities for export, like obtaining license, payment of export duty, have to be borne by the seller. If customary, the seller should provide the buyer with the usual transport document.

The buyer, on receipt of intimation from the seller, may arrange for insuring the goods. He should arrange for getting import license and pay import duties. If he requires the seller to furnish him with certificate of origin or any other document, he should reimburse the seller for the expenses.

Documents to be submitted by the seller are:

Freight paid waybill,

Invoice, and

Other documents as required by the buyer.

CIP – Carriage and Insurance Paid to (named place of destination)

This term corresponds to CIF contract under sea transport. In addition to the obligations under „carriage Paid to" contract, the seller should arrange for insurance for the goods and furnish the buyer with the insurance policy or other acceptable document. Therefore, the price quoted includes cost of the goods, freight charges and insurance premium.

The cargo insurance should be on such terms that the buyer would be entitled to claim directly from the issuer. Unless otherwise agreed it should be for 110% of the contract value with minimum cover of the Institute Cargo Clauses. When required by the buyer, the seller shall provide at the buyer"s expense war, strikes, riots and civil commotion risk insurances if procurable.

NOTES

In all other respects, the responsibilities of the seller and the buyer are same as under „Carriage Paid to" contract.

Documents to be submitted by the seller are:

Freight paid waybill,

Insurance policy, invoice, and

Other documents as required by the buyer.

DAF – Delivered at Frontier (named place)

Under this contract, the seller"s obligations are fulfilled when the goods have arrived at the frontier, but before the customs border of the adjoining country. To avoid misunderstanding, the parties may indicate (i) the countries separated by that frontier, and (ii) the name of place of delivery. For example, "delivered a Franco – Italian Frontier (Modane)".

The seller should arrange for packing the goods, checking operations where required, procure exchange control authorization required for exportation of the goods, contract for transportation of the goods to the place named in the contract and bear all risks and expenses up to this stage. If no particular point (station, pier, quay, wharf, warehouse as the case may be) as the named place of delivery is stipulated in the contract, the seller may choose any point for delivery. He should provide the goods at the frontier. The document may be a transport document or warehouse warrant. He may assist the buyer, at the latter"s request and, cost in obtaining other documents that may be required.

The buyer should arrange for taking delivery of the goods at the frontier. He should obtain import license and pay import duties, taxes and fees that may be required for this purpose.

Documents to be submitted by the seller are:

Document of transport or ware house warrant,

Invoice, and

Other documents as required by the buyer.

DDP – Delivery Duty Paid (named place of destination)

While the term "Ex Works" signifies the seller"s minimum obligation, the term "Delivered Duty Paid" when followed by words naming the buyer"s premises, denotes the other extreme – the seller"s maximum obligation. The seller has to do all that is necessary to place the goods at the premises of the buyer. He has to prepare the goods, pack them, arrange for the internal transportation, comply with the export and import formalities, arrange for the internal transport in the buyer"s country and ultimately place the goods at premises of the buyer. Till that time the risk in the goods also rests with the seller should provide the buyer with a customary document of transport warehouse warrant, dock warrant, delivery order or the like, as the case may be, to enable the buyer to take delivery of the goods. The seller retains the risks of the goods till they reach destination. The seller should reimburse the buyer for any assistance rendered by the buyer in getting import license, etc.

The buyer"s only duty is to take delivery of the goods at the destination.

If the parties wish that the seller should clear the goods for import but that some of the costs payable upon the import of the goods should be excluded – such as value added tax (VAT) and/or other similar taxes – this should be made clear by adding words to this effect: "Delivered Duty Paid, VAT unpaid (named place of destination)"

Documents:

Document of transport if required.

Invoice, and

Other documents as required by the buyer.

DDU – Delivered Duty Unpaid (named place of destination)

This term is similar to DDP except that the seller"s obligation excludes payment of duties, taxes and other official charges payable upon importation. If the parties wish

NOTES

the seller to carry out customs formalities and bear the costs and risks resulting there from this has to be made clear by adding words to this effect.

If the parties wish to include in the seller"s obligation some of the costs payable upon importation of the goods, such as value added tax (VAT), this should be made clear by adding words to this effect: "Delivered duty unpaid VAT paid (named place of destination)".

Documents:

Transport document, if required,

Invoice, and

Other documents as required by the buyer.

1.6 SUMMARY

BOP resumes all the economics operations between residents and non-residents. It appears in the form of either a deficit or a surplus. In order to understand this deficit, the means of it financing are to be arranged; long-term measures to accelerate exports and decrease imports are to be initiated. A persistent deficit or surplus is normally considered an indication of weaknesses and strengths of an economy. Whereas exchange rates are likely to go up in the case of „surplus" situation, their decreaseis likely to be inevitable in the case of the economy beset with persistent deficit.

1.7 Keywords used in the lesson:

Balance of payment

INCO TERMS

Current Account

1.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS:

1 Visible imports and exports

2 Sources, uses

3 Current

4 Net foreign Investment

5 Free Alongside ship

6 Free on Board

1.9 SHORT QUESTIONS:

1. What do you understand by Invisible imports and exports?
2. Give few examples for current account.
3. Explain briefly about the balance of payment.

ESSAY QUESTIONS:

1. Discuss the importance and limitations of Balance of Payment Statement.
2. Bring out some important INCO terms which are frequently used in International trade.

1.10 Further reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

NOTES

UNIT – II

METHODS OF PAYMENTS USED IN FOREIGN TRADE

UNIT STRUCTURE

2.1 Introduction

2.2 Unit Objectives

2.3.1 Payment methods

2.3.2 Marine Insurance policy

2.3.3 Bill of lading

2.3.4 Insurance Documents

2.3.5 Other Documents

2.4 Summary

2.5 Key words used in the lesson

2.6 Further reading

2.7 Answers to check your progress questions

2.8 Model Questions

2.1 INTRODUCTION:

In International trade, we require some knowledge about the important payment terms and methods of effecting payment; it would be very useful to understand the export financing methods and process. The credit requirement of the exporter depends to a very large extent on the sale terms.

A sale contract should clearly specify when the payment will be made, where it will be made and how it will be made. As the payments terms are determined on the basis of the specific circumstances of the particular buyer and seller, it would be difficult to make any generalization about payment terms. However, there are certain standard terms, which are in common use.

2.2 OBJECTIVES OF THIS UNIT:

1. to understand the various payment methods used in international trade;
2. to know the procedures adopted in making payments in international trade,

NOTES

2.3. PAYMENT METHODS

2.3.1.1 Clean Payments

In clean payment method, all shipping documents, including title documents are handled directly between the trading partners. The role of banks is limited to clearing amounts as required. Clean payment method offers a relatively cheap and uncomplicated method of payment for both importers and exporters.

2.3.1.2 Cash in Advance

The most advantageous payment term from the seller"s point view is the remittance with the order, or sometimes, before the shipment, before the shipment of goods. The remittance may be made by draft, cheque, mail of telegraphic transfer. Very seldom is an importer prepared to make cash payments in advance; out in certain cases it becomes necessary. For instance, advance payment may be insisted upon when goods ordered are those manufactured to order in accordance with the specifications of the buyer. Further when the buyer is unknown to the seller or his creditworthiness is doubtful, the seller would like to get the payment in advance.

If the seller enjoys a monopoly position or if there is a seller"s market, it is easy to obtain advance payment; but when the market is very competitive, it is very difficult to do so.

Check Your Progress

1. Under trading on open account, the exporter does not require _____ any_____.

2.3.1.3 Open Account

Under trading on open account, the exported ships the goods with no financial documents to his advantage accept the commercial invoice. Under this method, therefore, the seller carries the entire financial burden with little or no documentary

evidence. Because of the great risks associated with the open account method, it is generally restricted to cases of transactions between interconnected companies, or where the exporter and overseas buyers have has a long and well - established commercial relationship, and when there are no exchange restrictions that complicate the settlement. India exporter are allowed to sell abroad on the open account basis only with the special permission of the Reserve Bank of India, Normally, this permission is given only to foreign companies operating in India.

2.3.1.4 Consignment sale

Under the consignment sale, the exporter consigns the goods to his agent or representative in the foreign markets, who arranges for the sale of the goods and makes payments to the exporter. Goods consigned abroad include tea, coffee, wool, etc., which cannot be easily standardized. Under this method, the exporter retains the title to the goods until the sale of the goods is affected in the foreign market. The consignment sale involves a number of risks for the exporter. As no bill of exchange is involved under this method, the seller is not protected against default. He is also exposed to such risks as exchange fluctuations and the loss that may arise if the consignee is inefficient or is not sincere and honest.

An Indian exporter selling goods on consignment basis must furnish a declaration regarding the full export value of the goods or, if the full export value of the goods is not ascertainable at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in the overseas market.

2.3.1.5 Documents against Payment

Under the D/P terms, also known as cash against documents (c.a.d), the exporter ships goods to the foreign buyer, but the documents giving title to the goods will be handed over to the buyer through the bank only on payment. Under this type of transaction, until and unless the buyer makes the payment, the ownership of the goods remains with the seller.

The exporter may obtain bank finance against D/P bills usually on with recourse basis, so that, in the event of nonpayment by the drawee the bank has recourse to the drawer.

2.3.1.6 Documents on Acceptance

Under the D/P method, the documents and the title to the goods are handed over to the buyer when he accepts the bill or exchange by signing it. The usance of the bill of exchange may be 30 days, 60 days or 90 days. The exporter, thus, extends credit to the importer for such period. Under the D/A terms, the exporter relies on the honesty and creditworthiness of the proven business integrity and financial standing. Banks may extend finance to exporters by purchasing the D/P bills with recourse.

Check Your Progress

2. Under the D/P method, the usance of the bill of exchange may be _____

2.3.1.7Documentary Letter of Credit

The documentary letter of credit covers the major part of the export business of the world. A letter or credit is a document containing the guarantee of a bank to honour drafts on it by an exporter, under certain conditions and up to certain amounts. Instead of being drawn on the importer, the draft is drawn on the importer"s bank. A letter of credit eliminates the risk for an exporter, for he will be definitely paid for his shipment provided, of course, that he fulfils his obligations. He, therefore, ordinarily requests the importer to arrange for a letter of credit from the point of view of nonpayment, an important advantage of a documentary letter of credit from the point of view of the exporter is that, immediately after the shipment of the goods, he can present the bill of exchange and other relevant documents and obtain payment from a bank at his own centre. For details of the letter of credit financing the exporter has to wait for a period of time-short, medium or ling-even after the shipment of goods to obtain payment from the overseas buyer. He has, therefore, to arrange for post-shipment finances, covering the period between the shipment of the goods and the receipt of payment. All the countries which are serious about export promotion, have, therefore, made institutional arrangement for the provision of both pre - shipment finance. In India, the export sector is regarded as a priority sector.

2.3.1.8. Pre – Shipment Credit

As the name indicates, pre – shipments finance, also known as packing credit, refers to the credit extended to the exporter prior to the shipment of goods. Pre – shipment credit enables his to meet his working capital requirements for the purchase of raw materials and components, processing. Packing, transportation, warehousing, etc. packing credit is short-term finance. It is also advanced against export incentives.

In India, pre – shipment credit is provided by India and foreign commercial banks which are members of the Foreign Exchange Dealer Association. The packing credit advances by commercial banks in India are governed by the Packing Credit Scheme of the Reserves Bank. The features of this scheme are:

Check Your Progress

3 Pre – shipments finance, also known as_____

The loan is advanced only on receipt of an export order.

To obtain the loan, the exporter should deliver to the bank either a letter of credit established in his favour or a confirmed export order. However, where the letter of credit or the confirmed export order is yet to be received, relevant evidence in form of a cable, letter etc., contains information regarding at least the value of the order, the quantity and particulars of goods, the date of shipment and name of the buyer.

All the packing credit advances must be repaid from the proceeds of the relative export bills negotiated or from the remittance received from abroad for the relative goods.

Packing credits are eligible for interest subsidy, normally for a period not exceeding 90 days, although the credits may be given for a period of 180 days for specified items, such as engineering goods, with the permission of the Reserve Bank of India. In genuine cases of delay of shipment of specified items, a further period of 90 days may be allowed by the Reserve Bank of India.

Packing credit is also available against certain incentives; such advances should be repaid by the exporter as soon as these are realized.

In terms of the Reserve Bank directive, banks are required to provide finance (which includes packing credit facilities) at a concessional rate of interest, which is

specified by the Reserve Bank from time to time. No service charges are leviable other then those stipulated by the Foreign Exchange Dealer Association of India. The premium payable to export Credit Guarantees may, however, be charges to the exporter.

Where a letter of credit or an export order is received in the name of an export house or any merchant exporter, an advance made even to a sub-supplier falls within the packing Credit Scheme. In such a case the sub-supplier should submit to the bank a letter from the export house/merchant exporter, giving details or export house/merchant and of the supply allotted, and confirming that the export house/merchant exporter will not avail it/him of packing credit from any other source on the quantity so allotted. Since export bills are negotiated in the name of the export house/merchant exporter, will not avail it/him of packing credit from any other source on the quantity so allotted. Since export bills are negotiated in the name of the export house/merchant exporter, will not avail it/him of packing credit should be made by inland letter of credit opened by the export house/merchant exporter in favour of the sub-supplier, or proceeds of bills drawn by the sub-supplier on the export house/merchant exporter. Whenever the bill on the export house/merchant exporter is not accompanied by a bill of lading, a certificates should be made by inland letter of credit opened by the export house/merchant exporter in favour of the sub-suppliers, or by proceeds of bill on the export house/merchant exporter is not accompanied by a bill of lading, a certificate should be obtained from the export house/merchant exporter for every quarter, stating that the goods have actually been exported.

An undertaking from the sub-supplier shall be obtained that any advance payment received towards the supply of goods would be adjusted to the packing credit.

2.3.1.9 Post-Shipment Finance

As has already been mentioned, the international market is, by and large, very competitive, and the extension of credit facilities to the buyers is one of the important determinants of the expansion is the export business. Most exporters are not in position to extend credit to overseas buyers. To promote the export business, therefore, the burden of credit should shifted from the exporters by either the financial institutions

providing credit, directly or indirectly, to the buyers, or by extending credit to the exporters to enable them to extent credit to their buyers. Accordingly, financial institutions provide buyer"s credit, line of credit, and supplier"s credit.

Supplier's Credit

Under the Buyer"s Credit system, credit is extended to overseas buyer by either a financial institution or a consortium of financial institutions. This credit enables the buyer to pay for the goods he imports, if the financial institution that provides the buyer"s credit is located in the exporter"s country. The loan does involve a transfer of funds from the Supplier"s country to the buyer"s country; the exporter may obtain the payment directly from the financial institution on presentation of the relevant export documents. Buyer"s credit is generally advanced for capital goods.

Check Your Progress

4. Under the Buyer"s Credit system, credit is extended to overseas buyer by_____

2.3.1.10 Line of Credit

When a number of buyers are involved, instead of negotiating credits with each one, the financial institutions in the supplier"s country may extent a line of credit of a financial institution in the buyer"s county which, in turn, will disburse the credit to the buyers in respect of approved transaction. Apart from avoiding the problem of dealing with several individual transactions, the great advantage of the line of credit is that the responsibility for judging the creditworthiness of the buyers is shifted to the financial institution in the buyer"s country.

2.3.1.11. Shorts-Term Finance

Short-term post-shipment credit is usually provided by the commercial banks, mainly by negotiating documents under letter of credit, by purchasing D/P bills, by lending against export bills tendered for collection abroad, and by advancing money against such receivables as export incentives like cash assistance, refund of excise and customs duty and reimbursement of the differentials between indigenous and international prices of certain raw materials.

2.3.1.12 Medium and Long-Term Finance

In India, commercial banks, which provide most of the short-term post-shipment credit, plays an important role in offering medium and long-term post-shipment fiancé. The industrial Development Bank of India (IDBI) played a very important role in long-term post-shipment finance. It provided refinance facilities to commercial banks against the long-term export credit extended by them, and had a scheme for direct financial assistance to exporters in collaboration with approved commercial banks. The IDBI was also operating a Buyer"s Credit Scheme for the promotion of capital goods exports from India. Under this scheme, it provided credit to eligible foreign buyers for the purchases of goods from India.

With the establishment of the Export Import (EXIM) Bank in 1982, export credit functions performed by the IDBI were transferred to the EXIM Bank.

Check Your Progress

5. Export Import (EXIM) Bank was established in the year

_____

2.3.2 MARINE INSURANCE POLICY

2.3.2 Marine Insurance Policy:

2.3.2.1 Meaning and Need

The safe conduct of the goods from the time it leaves the exporter"s godown and till it reaches the warehouse of the importer is what all parties in the transaction pray for. It depends upon the safety of the good during the voyage as well as the safety of the vessel that carrier the goods. The loss of or damage to goods during the voyage would affect any one or more parties involved the transaction, viz., the importer, the exporter, the shipping company and the bank a which has paid against the documents covering the goods. Marine insurance offers the desired cover against loss of or damage to the goods during the transit. It allows a free flow on international trade by absorbing an important uncertainty connected with it.

In India marine insurance is governed by the Marine Insurance Act, 1963. Section 3 of the Act defines a contract of marine insurance as "an agreement whereby the

insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say, the losses incidental to marine adventure"

Check Your Progress

6 Define Marine Insurance.

2.3.2.2 Scrutiny of Bills Drawn under Letter of Credit

Bills under a letter of credit may be received for negotiation from a customer of the bank. Bills may also be received from a person other than the customers of the bank, where the credit is restricted to it or it is named the paying banker under the credit is restricted to it is named the paying banker under the credit. While negotiating documents under a letter of credit, the bank will adhere to the principle of strict compliance. That is, the documents presented should agree with the stipulation of the credit in toto. Non-compliance with the terms of the credit, however minor such discrepancy may be, would provide a ground for the issuing bank to reject the documents and refuse payment under the credit.

When approached to negotiate document under a credit, the bank should verify the credit itself to see that it is valid (i.e., it has not expired); that it attaches no onerous clauses on the negotiating bank and that payment is not made conditional. It should verify individual documents tendered and satisfy that they are in agreement with the terms of the credit. Any alteration in the document should have been authenticated. Further it should scrutinize documents inter se (i.e., one with the other, like bill of lading with invoice) to see that there is no discrepancy. The common discrepancies that may be found in the documents tendered under a letter of credit are listed below:

The discrepancies listed are by no means exhaustive.

Bill of exchange

The bill is drawn on the importer instead of on the issuing bank as required in the credit.

Reference to the letter of credit is missing.

Tenor of the bill is different from that required under the credit.

Interest clause is missing, where stipulated.

Amount in words and figures differs.

In case of usance bill, it is inadequately stamped/unstamped.

The name of the party is mis-spelt.

It is not drawn/signed by the beneficiary of the credit.

The bill is not drawn payable/endorsed to the bank.

2.3.2.3 Invoice

The invoice is not addressed to the importer.

The amount exceeds the limit under the credit or the unit price exceeds that mentioned in the credit.

The amount differs from that mentioned in the bill of exchange.

The details of the cost, insurance and freight and other charges are not shown separately where it is required under the credit.

The description of the goods does not agree with the description in the credit.

The number o packages/quantity differs from the credit requirements. The difference may be with respect to the quantity or number of packages mentioned in the bill of lading also.

Invoice is not certified as correct/signed by the exporter.

It does not certify the origin of goods, where a certified invoice is required.

Any other certification required by the credit is not furnished with the invoice.

Reference to the import license number as required by the credit is missing.

The markings, etc. differ from that appearing on the bill of lading.

Charges not permitted by the terms of contract are included.

The number of copies is less than the number required.

2.3.3 Bill of Lading

The full set of negotiable copies of bill of lading is not submitted. The bill of lading would mention the number or copies issued. All copies are to be submitted.

Bill of lading is clause.

Bill of lading is not manually signed by the master or an authorized agent of the shipping company (rubber stamp to acceptable).

The number of packages/weight differs from that in invoice.

Bill of lading is issued by forwarding agents.

Bill of lading does not indicate that goods have been received onboard the ship.

Bill of lading indicates that goods are carried on deck.

Where the credit is on CFR of CIF basis, freight payable bill of lading is submitted instead of freight paid bill of lading.

Bill of lading is drawn with the importers consignee instead of the exporter.

It is not endorsed in blank or in the name of the bank as required.

The bill of lading is dated subsequent to the latest date of shipment.

Bill of lading is presented after undue delay. That is, it is presented after the time allowed in the credit or, where there is no provision in the credit it is presented after 21 days from the date of issue.

Bill of lading indicates transshipment when it is not allowed under the credit.

Description of goods does not agree with the invoice.

Port of shipment and port of destination do not agree with the stipulations in the credit.

Bill of lading is issued under a charter party.

Bill of lading indicates a third party as shipper when it is prohibited by the credit.

The notation „on board" on a received for shipment bill of lading is not authenticated by the carrier or his agent.

Check Your Progress

7 Bill of lading is to be presented within _____ days from the date of issue.

2.3.4 Insurance Documents

The amount covered is low. The minimum coverage should be for CIF value plus ten percent.

Insurance is expressed in a currency other than the one in which the credit is drawn.

Risk covered does not agree with the requirements of the credit.

Insurance does not cover the entire voyage.

Description of goods and shipping marks do not agree with the invoice.

The name of the vessel indicated differs from that in the bill of lading.

Insurance policy is not endorsed in blank.

Insurance certificate is not countersigned by the shipper.

Insurance policy is dated later than the date of bill of lading.

The place of settlement of claims differs from that in the letter of credit.

Insurance policy is not in negotiable form.

It is not properly stamped.

Where more than one negotiable copy is issued, all copies are not submitted.

Transshipment risk not covered, while credit allows transshipment.

Cover note is submitted when credit insists on policy.

2.3.5 Other documents

The document tendered is not issued by the authority specified in the letter of credit.

The little of document differs from that required.

The description of goods differs from that in the invoice/credit.

Certification/Declaration, if any required by the credit is not made.

2.3.5.1 Dealing with Discrepancies in Documents

When the bank is satisfied that the documents tendered under a letter of credit satisfy the requirement of the credit, they may be negotiated and amount paid to the customer. Where the documents tendered under a letter of credit show some discrepancies, the bank would point out such discrepancies to the exporter and ask him to get them rectified. This would be possible if the discrepancies are in the documents prepared by the exporter himself. For example, if the description of goods in the invoice differs from that in the letter of credit, the exporter can suitably alter the invoice and resubmit to the bank.

The discrepancy in the documents may be such that they cannot be rectified by the exporter. For instance, the bill of lading is clause or a shipment is later than that allowed in the credit. Where the discrepancy cannot be rectified the bank may elect to negotiate depending upon (i) the nature of the discrepancy, (ii) the worth of the party, (iii) the experience of the bank in handing documents relating to transactions between the

exporter and the particular importer in the past. Depending upon these factors, the alternatives available to the bank are:

Confirmation of opening Bank Account

It may intimate the credit opening bank of the discrepancies and seeks their confirmation. The opening bank will, in turn, consult the intimate the negotiating bank its permission to negotiate the bill. When such permission is received, it amount the amendment of the credit to the effect, but only in respect of the particular transaction and, therefore, the bank can negotiate the documents. If the exporter wants the money urgently, the list of discrepancies may be sent and the reply sought by the exporter. Will seeking confirmation by cable or letter, the bank should take care to include all the discrepancies found precisely and completely.

2.4 SUMMARY

Even where the confirmation of the opening bank is sought by cable, it takes some time to get it. If the party is in urgent needs of funds and cannot wait and the bank"s rating of the customer is high, the documents may be negotiated under reserve. That is, the documents are negotiated by the bank on the understanding that if the documents are not accepted by the opening bank and the negotiating bank is not reimbursed, the negotiating bank shall have the right to receive bank the amount paid to the exporter along with.

2.5 KEYWORD USED IN THE LESSON

Payment methods in foreign trade

Letter of credit

Marine insurance policy

2.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS;

1 Any document

2 30 to 90 days

3 Packing credit

4 Financial institutions

5 1982

6 Section 3 of the Act defines a contract of marine insurance as "an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say, the losses incidental to marine adventure"

7 21 days

2.7 Model questions

1. What is clean payment?
2. What do you understand by consignment sale?
3. Explain Documents Against Payment.
4. Briefly explain about Bill of lading.
5. Explain about Post-shipment finance.

2.8 ESSAY QUESTIONS:

1. Describe the various payment methods followed in International Trade.
2. Explain in detail about Marine Insurance policy.
3. Bring out the various insurance documents to be supported in International Trade.

2.9 FURTHER READING

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

UNIT - III

TYPES OF LETTERS OF CREDIT

NOTES

3.1 Introduction

3.2 Unit Objectives

3.3 Payment, Acceptances and Negotiation Credits

3.4 Revocable and Irrevocable Credits

3.5 Confirmed and Unconfirmed credits

3.6. With Recourse and Without Recourse Credits

3.7 Fixed and Revolving Credits

3.8 Transferable Credits

3.9 Back-to-Back Credits

3.10 Red Clause and Green Clause Credits

3.11 Standby Credits.

3.12 Bill of Exchange

3.13 Financing of foreign trade

3.14 Role of Commercial Bank

3.15 Summary

3.16 Key words used in the lesson

3.17 Answers to check your progress questions

3.18 Model Questions

3.19 Further reading

3.1 INTRODUCTION

A letter of credit may be a clean credit or a documentary credit. A documentary credit requires the documents of little to goods and other documents to accompany the bill drawn under the credit. No such documents are necessary for a clean letter of credit.

Under a clean letter of credit, the documents of title to goods (bill of lading, for example) are dent by the exporter to the importer direct. Only the bill of exchange drawn on the importer is offered to the bank for purchase. Neither the exporter nor the bank retains control over the goods covered by the transaction. For the bank it remains an unsecured advance. For this reason, clean letter of credit is normally not found in commercial transaction. They are used for transfer of funds between banks. In exceptional cases they may be accepted from first class customers.

Almost all-commercial letters of credit (issued for financing foreign trade) are documentary credits. Therefore, the UCP deals only with documentary credits. A documentary credit may be classified under the following types depending upon the particular provisions it contains:

Payment, Acceptances and Negotiation Credits

Revocable and Irrevocable Credits

Confirmed and Unconfirmed credits

With Recourse and Without Recourse Credits

Fixed and Revolving Credits

Transferable Credits

Back-to-Back Credits

Red Clause and Green Clause Credits

Standby Credits.

3.2 UNIT OBJECTIVES

* to understand the various types of credit which are used in international trade

* to know the various types of bill used in payment

3.3 PAYMENT, ACCEPTANCE AND NEGOTIATION CREDITS.

NOTES

Article 10 (a) stipulates: "All credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation"

Thus a letter of credit may be

Payment credit (or, sight payment credit);

Negotiation credit;

Acceptance credit; or

Deferred payment credit

Payment Credit

A payment credit provides that payment will be made to the beneficiary against the documents submitted by him. The documents are not accompanied by a bill of exchanges; if there is one, it is drawn on the paying bank. In certain countries even sight drafts attract stamp duty. To avoid stamp duty the parties may agree for payment credit. Therefore payment credits normally avoid drawing bills of exchange.

In a payment credit the issuing bank nominates a bank in the exporter's country as the paying bank. If the paying bank accepts its nomination, its position is that of an agent of the issuing bank. When the documents under the credit are presented to it, it pays the beneficiary. It gets reimbursement from the issuing bank for the amount paid.

Negotiation Credit

In a negotiation credit the documents are accompanied by a sight draft (bill of exchange). The bill of exchange may be drawn on the issuing bank or any other bank stipulated in the credit. The bank which negotiates documents under the credit purchases

NOTES

the bill of exchange and pays the amount to the beneficiary who tenders the documents. The negotiating bank is reimbursed by the issuing bank.

It may be noted that 1993 Revision of UCP provider [Article 9 (b) (iv)] that a credit should not be issued available by drafts(s) on the applicant. If the credit nevertheless calls for drafts(s) on the applicant, banks will consider such draftg(s) as an additional document. This provision stresses the point that the obligation to pay under a letter of credit is primarily that of the issuing bank.

Article 10 (b) provides that unless the credit stipulates that it is available only with the issuing bank, all credits must nominate the bank which is authorized to negotiate. In a freely negotiable credit, any bank is a nominated bank. Thus the negotiating bank may be specifically nominated by the credit; or any bank where the credit is freely negotiable.

Check Your Progress

1. In a negotiation credit the documents are accompanied by a -

Restricted Letter of Credit

The issuing bank may restrict the negotiation of documents under the letter of credit to a specified bank in the exporters country. The letter of credit contains a provision: Negotiation under this credit restricted to Bank (name of the bank). The exporter may submit the documents for negotiation to the bank specified in the credit. If the exporter"s bank is not the negotiating bank under the credit, it may still purchase the document, depending upon the credit enjoyed by the customer with his bank. The exporter"s bank which purchases the documents has to the negotiating bank, to whom the credit is restricted, to obtain payment.

Where a letter of credit is restricted to another bank, the exporter"s bank does not readily agree to purchase the documents under the credit because

(i) it is not a foreign exchange transaction for the bank; it has to present the documents to the bank nominated in the credit and obtain payment in Indian rupees;

(ii) it is not a negotiating bank and, therefore does not enjoy the privileges of negotiating bank under Uniform Customs and practice.

Restriction of letter of credit may be resorted to by the opening bank under instructions from the applicant of the credit, or it may be done to confine business to a favored bank (or the same group or a correspondent bank). If the beneficiary wishes to negotiate the documents through his own banker, he may require suitable amendment of the credit removing the restriction.

Open Letter of Credit: The letter of credit contains an open invitation to bank to negotiate documents under the credit. The commitment of the issuing bank may read as follows: "We hereby engage with drawers and/or bonafide holders that drafts and negotiated in conformity with the terms of this credit will be duly honored on presentation".

Acceptance Credit

An acceptance credit calls for a usance bill of exchange of a specified period to be drawn under the credit. For instance, the letter of credit may require the exporter to draw "90 days" bill. The advantage under an acceptance credit is that the buyer needs not pay immediately; he pays only on the due date of the bill. The seller gets the bill accepted by the bank and, in case he is in need of funds, discounts it with his bank. Thus the seller can also get payment immediately. The duty of the issuing bank under this credit is not only to see that the bill is accepted but also to ensure payment on maturity.

If the bill is drawn on the accepting bank in the exporter"s country, the accepting bank will accept the bill and return it to the beneficiary. The documents are forwarded to the issuing bank. If the beneficiary is in need of funds he may discount the bill with any other bank or finance house. Since it is banker"s acceptance, the bill will be discounted readily by other banks and at favourable rates.

On receipt of documents, the issuing bank will deliver them against Trust Receipt or on clean basis. It may also hold them until the steamer arrives, arranges clearance and then stores the goods under it control. A loan against pledge of goods may be repaid by the sale proceeds of the goods.

Deferred Payment Credit

A deferred payment credit carries an undertaking of the issuing bank to pay or to arrange for payment on the date(s) determinable in accordance with the stipulations of the credit. It is like an acceptance credit with the exception that no drafts are drawn. It is thus considered inferior to acceptance credit from the beneficiary"s point of view because he does not get a banker"s acceptance which he could discount and raise finance.

Deferred payment credit may be used where the beneficiary wishes to allow the importer time to pay for the documents. The documents will be delivered to the importer immediately. This type of credit is also used to finance import of plant and machinery and capital goods on deferred payment basis. The exporter in such cases can ask the importer to-

Effect remittance of the agreed advance payment, and to submit a „Deferred Payment Guarantee" from his bank for the deferred installments, or

Open a deferred payment letter of credit providing for advance payment against shipping documents and payment of deferred installments as and when due.

Deferred payment letter of credit is easier to operate and, therefore, the exporter may prefer this to deferred payment guarantee.

3.4 REVOCABLE AND IRREVOCABLE CREDIT

A credit may either (i) revocable, or (ii) irrevocable. The credit should therefore clearly indicate whether it is revocable or irrevocable.

A revocable credit is one which can be cancelled or amended by the issuing bank at any time without prior notice to the beneficiary. The cancellation, or amendment, however, takes effect against the bank which has negotiated bills under the credit only on receipt of notice of such cancellation, or amendment. The issuing is liable for bills negotiated conforming to the terms and conditions of the credit before the notice or revocation is received by the negotiating bank.

Since there is no definite undertaking by the issuing bank in a revocable credit, there is not much of a benefit under the credit to the exporter. If the credit is advised to him by the opening bank direct, it ma be cancelled by the issuing bank at any time without prior notice. Therefore, till he receives payment from the issuing bank the exporter is not sure whether the credit is current. He would find it difficult to negotiate the bill with any bank in his country. The bank in the exporter"s county is not aware if the credit is cancelled and hence would be reluctant to negotiate the bill.

If credit is advised through a bank, generally there would be a clause under which the issuing bank binds itself liable to reimburse the negotiating bank on any bills negotiated before the notice of cancellations is received by it. Therefore, such bills have better reception from the negotiating banks. Still the exporter has the risk that the credit may be cancelled at any time after he procures the goods but before he presents the bill for negotiation.

A revocable credit does not confer the benefit that an exporter expects when he requires a letter of credit to be opened in his favour, viz., assured payment when he ships the goods. The exporter agrees to a revocable letter of credit only when he has to choose

Article 8

A revocable credit may be amended or cancelled by the issuing bank at any moment and without prior notice to the beneficiary.

However, the issuing bank is bound to reimburse another bank with which a revocable credit has been made available for sight payment, acceptance or negotiation – for such payment, acceptance or negotiation made by such bank prior to receipt by it of notice of amendment or cancellation, against documents which appear on their face to be in compliance with the terms and conditions of the credit.

A revocable credit indicates its nature by a specific clause, addressed to the advising bank, on the following lines:

When advising the beneficiaries kindly make it clear to them that credit is revocable and therefore subject to cancellation. We hereby undertake to reimburse you

Check Your Progress

2 A revocable credit can be cancelled or amended by the

_____

for all drafts honored by you in accordance with the terms of the credit prior to your receiving notice of cancellation.

An irrevocable credit constitutes a definite undertaking of the issuing bank to accept and/or to pay bills drawn on it or another bank or make payment (without a bill) provided the terms and conditions of the credit are complied with. An irrevocable credit can neither be amended nor cancelled without the agreement of all parties concerned.

Under an irrevocable letter of credit, the exporter can be safe with the knowledge that the bills drawn under the credit will be honored by the issuing bank provided the conditions of the letter of credit are fulfilled. Any amendment or cancellation of credit is not effective unless the exporter also consents to such an amendment or cancellation. Bills drawn under an irrevocable credit are readily negotiated.

The difference between a revocable credit and an irrevocable credit is quite clear. While a revocable credit can be cancelled or modified without the consent of the exporter, it is not possible in the case of irrevocable credit.

If the credit does not indicate whether it is revocable or irrevocable, it shall be deemed to be irrevocable.

[Article 6(c)]

Prior to 1993 revision of UCP such credit were treated as revocable.

[Article 9 (a)

An irrevocable credit constitutes a definite undertaking of the issuing bank, provided that the stipulated documents are presented to the nominated bank or the issuing bank and that the terms and conditions of the credit are complied with:

If the credit provides for sight payment – to pay on the maturity date(s) determinable in accordance with the stipulations of the credit;

If the credit provides for acceptance:

By the issuing bank – to accept and pay maturity draft(s) drawn by the beneficiary on the issuing bank in the event the drawee bank stipulated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity.

Of the credit provides for negotiation to pay a without resource to drawers and/or bonafide holders, draft(s) drawn the beneficiary and/or document(s) presented under the credit. A credit should not be issue available by draft(s) on the applicant; banks will consider such draft(s) as an additional document(s).

Amendments to Credits

Let us see what an amendment of the credit is. After a credit has been issued it may be felt necessary to alter some of the stipulations of the credit or delete some or add some more. All these modifications are communicated through the same bank that advised the credit. The credit issuing bank intends that all the amendments from an integral pat of the original credit issued.

The issuing bank shall be irrevocably bound by an amendment issued by it from the time of issuance of such amendment [Article 9 (d) (ii)]. However, the beneficiary may elect not to accept the amendment in which case the liability of the issuing bank remains as per the credit originally advised. The terms of the original credit will remain in force for the beneficiary until the beneficiary communicates his acceptance to the amendment to the bank advised such amendment [Article 9 (d) (iii)].

The beneficiary should give notification of acceptance or rejection of amendment. If the beneficiary fails to give such notification, the tender or documents to the nominated bank or issuing bank, that conforms to the credit with amendment, will be deemed to be notification of the acceptance by the beneficiary of such amendment and as of that moment the credit will be amended. [Article 9(d) (iii)]. By implication, if the beneficiary without giving notification tenders documents conforming to the original credit, it will be deemed to be his rejection of the amendment.

One advice of amendments may contain more than one factor. For instance, Amendment No.1 to a letter of credit may (a) increase the amount from $5,000 to $5,5000 and (b) expiry date of the credit revised from 11-11-1993 to 10-10-1993. The beneficiary should either accept both (a) and (b) or reject both. Partial acceptance of the amendment contained in one and the same advice of amendment is not allowed and consequently will not be given any effect [Article 9 (d) (IV)]. Thus the beneficiary cannot accept (a) and reject (b). However, the beneficiary has the right to accept on amendment and reject another. Thus he may accept Amendment No.1 issued on 25-02-1993, but reject Amendment No.2 issued on 27-02-1993.

If bank uses the services of an advising bank to have the credit advised to the beneficiary, it must also use the services of the same bank for advising and amendment [Article 11 (b)].

3.5 CONFIRMED AND UNCONFIRMED CREDITS

When a letter of credit is advised to the beneficiary through a bank in the beneficiary"s country, it may request the other bank to add its confirmation or merely advise the credit to the beneficiary without adding its confirmation. If the advising bank adds confirmation to the credit, it becomes a confirming bank and the credit a confirmed credit.

Confirmation is a definite undertaking of the confirming bank, in addition to the undertaking of the issuing bank, to accept and/or pay bills or make payment (without bills) provided the term and conditions to the credit are satisfied. When the advising bank confirms a credit, it undertakes to negotiate bills drawn under the credit without recourse to the drawer.

All confirmed credits are also irrevocable letters of credit. It is so because no bank in the exporter"s country would be willing to undertake a liability on a revocable credit on which there is no definite undertaking by the issuing bank.

A confirmed irrevocable credit is the best form of credit available to the exporter as it has the following added advantage:

It insures the exporter not only against the failure of the importer but that of the issuing bank also. Though a letter of credit bears the superior credit of a bank in the importer"s country, the exporter may not know the financial standing of the issuing bank. When the credit is confirmed by a bank, which he knows well, he is more secure.

It also saves the beneficiary from changes in the Government policies or disturbances in the political situation of the importer"s country. Irrespective of these changes the beneficiary is assured of payment by the confirming bank.

When the advising bank does not add its confirmation, but merely forwards the credit to the beneficiary, the credit remains unconfirmed. The advising of the credit through a bank serves in such a case to get the signature of the issuing bank on the credit authenticated by the advising bank. There is no additional undertaking by the advising bank.

The advising bank will add its confirmation only when there is a specific request from the issuing bank. It will not do so solely at the request of the beneficiary. The request from the issuing bank to add confirmation may be in the credit itself or in the covering letter. Unless the issuing bank specifies otherwise in its confirmation, authorization or request, the advising bank will advise the credit to the beneficiary without adding its confirmation [Article 9 (c) (i)].

[Article 9 (b)

A confirmation of an irrevocable credit by another bank (the confirming bank upon the authorization or request of the issuing bank, constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that the terms and conditions of the credit are complied with:

If the credit provides for sight payment – to pay at sight;

If the credit provides for deferred payment – to pay on maturity date(s) determinable in accordance with the stipulations of the credit;

By the confirming bank – to accept draft(s) drawn by the beneficiary on the confirming bank and pay them on maturity, or

By another drawee bank – to accept and pay at maturity draft(s) drawn by the beneficiary on the confirming bank, in the event the drawee bank stipulated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity;

If the credit for negotiation–to negotiate without recourse to drawers and/or bonafide holders, draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by draft(s) on the applicant. If the credit nevertheless calls for draft(s) on the applicant, banks will consider such draft(s) as an additional document(s).]

The request for confirmation would normally come from the correspondent bank which opens the letter of credit. The consideration for confirmation is the charges which it can recover from the issuing bank. But by confirming a credit, the bank assumes an independent liability for the reimbursement of which it has to rely on the opening bank. Therefore, each bank assesses its other correspondent bank and places a limit up to which it confirm the credit is issued by the other bank. When a request for confirming a specific letter of credit is received, it should assess the position taking into account the limit sanctioned for the credit issuing bank, the country risk (political and economic situation in the country issuing the credit), the trade environment, the beneficiary, etc. If the bank is not prepared to add its confirmation, it must so inform the issuing bank without delay [Article 9 (c) (i)].

The confirming bank will not be bound by any amendment not routed though it. If an amendment to credit is advised to the confirming bank, it is up to the bank to accept or reject it. When a confirmed credit is amended, the confirming bank may extend its confirmation to the amendment and shall be irrevocably bound as the time of its advice of the amendment. A confirming bank may, however, choose to advise an amendment to the beneficiary without extending its confirmation and if so, much inform the issuing

bank and the beneficiary without delay [Article 9 (d) (ii)]. Forwarding the amendment by the confirming bank is taken to signify its acceptance of the amendment.

As per Article 2, branches of a bank in different countries are considered another bank. Hence a letter of credit opened by a bank can be confirmed by its branch in the exporter"s country.

3.6. WITH RECOURSE AND WITHOUT RECOURSE CREDITS

The bill of exchange drawn under a letter of credit may indicate that it is drawn without recourse to the drawer. Unless the credit authorizes drawing a „without recourse" bill of exchange, it is not proper to present such a bill of exchange.

A bill of exchange is only one of the documents drawn under the letter of credit and cannot be discussed in isolation of the legal import of the credit. Therefore, to understand the utility of drawing a „without recourse" bill of exchange, we should first know the recourse available to the parties involved, viz., the negotiating bank, confirming bank and the issuing bank.

The exporter"s intention in drawing a without recourse bill of exchange is to ensure that in case the documents are rejected by the issuing bank or payment is not made by the issuing bank for any reason, he should not called upon to pay bank the amount he received earlier on negotiation of documents.

As per Article 9, under an irrevocable letter of credit, both the issuing bank and confirming bank are required to negotiate documents without recourse to the drawers provided the documents tendered are in conformity with the terms of the letter of credit. Therefore, if the document tendered by the beneficiary is in conformity with the credit terms, there is no need to draw the bill without recourses if the credit is confirmed. Normally the documents are not sent by the beneficiary directly to the issuing bank; he negotiates them with a bank in his country. In the case of confirmed credit, the confirming bank"s undertaking is to honour bills without recourse and, therefore, the beneficiary is safe, irrespective of what transpires between the confirming bank and the issuing bank.

If the letter of credit is unconfirmed, the situation differs between a payment credit and negotiation credit. In a payment credit, the paying bank acts as an agent of the issuing bank. If the documents are accepted by it as conforming to the terms of credit, it has recourse against the drawer. If it wants to have recourse, it should pay under reserve, i.e., reserving the right to get back the money from the beneficiary if the documents are rejected by the issuing bank. Gutteridge and Megrah opine that the position should be the same in the case of a restricted letter of credit because the negotiating bank in that case is also acting as an agent of the issuing bank.

The position is different in the case of a negotiation credit which contains an open invitation for any bank to negotiate. In such a case, the negotiating bank acts on its own and is, therefore, a principal vis-à-vis the beneficiary. The condition under Article 10 that bank should negotiate without recourse does not apply to a negotiating bank. Therefore, if the negotiating bank is not reimbursed by the issuing bank, it can have recourse against the beneficiary for whom it has negotiated the bill. Similarly, "where the documents, apparently what they should be, are in fact not and the beneficiary (not fraudulent) is himself responsible for the discrepancy, the bank should be able to recover the money he has paid against them as paid in mistake of fact, unless he has expressly contracted not to have recourse".

But there is a difference between the credit being a „without recourse credit" and drawing the bill of exchange „without recourse". Where a bank is willing to waive its recourse it usually does so not by authorizing the beneficiary to draw without recourse but by the intimation that the credit is „without recourse" credit.

Gutteridge and Maurice Megrah state: "The beneficiary man" exclude liability by signing his draft „without recourse", but this is a defense only on the draft. If the documents are in order this drawer will in such circumstances be free from recourse altogether. But irregularity in the documents tendered will vitiate the intermediary banker"s promise or offer to negotiate and the drawing „without recourse" will be of no avail.

"The advantage of restricting liability on the draft only arises where, being a „time" draft, it becomes divorced from the documents and is in the hands of a transferee for value. There is no advantage to the drawer in a drawing without recourse where both draft and documents remain in the negotiating banker"s possession until they are presented to the issuing banker, except where for some reason the documents are refused by the latter". This is regarding drawing the bill of exchange without recourse.

As against this, regarding drawing the letter of credit without recourse, they state: "Whether or not a beneficiary is permitted do draw „without recourse" depends upon whether the buyer is willing to make provision for it in the credit – a matter to which he may not be indifferent. Practice varies considerably, both in regard to relieving the beneficiary of responsibility and to the method of doing so. For instance, some of the Eastern banks head their credits „Irrevocable Without Recourse Credit", the effect of which has not been judicially considered, in their desire to emphasize the irrevocable nature of their credits, though this is not the same as authorizing the drawing of drafts „without recourse" but amounts to an undertaking by the issuing bank not to have recourse. Sometimes also Eastern banks call for drafts on the buyers „without recourse", and authorize bank to honour the bill on a sight basis against immediate reimbursement by the issuing bank".

Check Your Progress

3 A fixed letter of credit is also known as

_____

3.7 FIXED AND REVOLVING CREDITS

A fixed or non – revolving letter of credits is one in which the limit is reduced permanently to the extent of bills drawn under the credit. If the limit is for Rs.10 lakhs only bills up to this value can be drawn under the credit.

Under a revolving letter of credit, the limit under credit is renewed as and when bills drawn under it are paid, to the extent of such bills. For example, if the credit is for a limit of Rs.10 lakhs and if already bills for Rs.4 lakhs have been drawn under it, the limit available for further negotiation is Rs.6 lakhs. If, among the bills already drawn, one for Rs.2 lakhs is paid, the limit is reinstated to this extent and now the limit available for negotiation is Rs.8 lakhs.

A credit, as in the above example, is termed non – automatic revolving letter of credit because the renewal of limit depends upon the receipt by the negotiating bank of payment advice form the issuing bank.

A credit is an automatic revolving letter of credit where the limits are renewed at fixed intervals irrespective of the fact whether the advice of payment has been received by the negotiating bank or not. For example, the credit may stipulate that the limits are Rs.1 lakh, renewed by negotiation of bills for this amount every week. The total drawing in such cases is controlled by specifying an expiry period. The credit may be „cumulative" or „non– cumulative". Under cumulative letter of credit, the amount unutilized during one period (week 0 is carried forward to the subsequent period. Under non – cumulative letter of credit, the amount unutilized during one period gets expired and cannot be utilized along with subsequent period"s quota.

As a variant of the above the letter of credit may not specify the period, but may stipulate that the total outstanding at any time should not exceed a specified limit.

A revolving letter of credit is useful where continuous transactions between the exporter and the importer are expected and the amount of each drawing is sought to be limited.

For exporter with a large contract spreading over a period of years, a revolving credit offers the following advantages:

He need not await receipt of letter of credit every time he exports; and

Since the same credit covers all the transactions the terms and conditions do not change.

It makes it easy for him to prepare documents as required by the credit.

Under exchange control regulations, opening of revolving letters of credit against import of goods into India is prohibited. However, occasionally, letters of credit may be

opened providing for payment against drafts at any one time within a fixed limit which is renewed automatically on the draft being honoured; but the aggregate drawings under the credit should be limited to the balance available on the import license.

A revolving letter should be distinguished for a fixed credit available by installments. Where the shipment is to be effected in parts, rather than in bulk, the credit may stipulate the periodicity and quantity of each shipment. For instance, the credit opened for $ 1, 20,000 for one year covering 1,200 tonnes of the commodity, may stipulate that every month the shipment should be 100 tonnes at the total price of $ 1,000. If within this monthly quota, partial shipment can be made, it should be clearly indicated so the credit. Article 41 provides: "If drawing and/or shipment by installments within given periods are stipulated in the credit and any installment is not drawn and/or within the period allowed for that installments, the credit ceases to be available for that and any subsequent installments, unless otherwise stipulated in the credit".

3.8 TRANSFERABLE CREDITS

A transferable credit is one under which the exporter has the right to make the credit available to third parties. The exporter may be only an intermediary who procures goods from the suppliers and arranges them to be sent to the importer. For example, Exporters India Ltd. May enter into an agreement for supply of handicraft and get a transferable letter of credit in its favour. It may procure the article from different manufactures to get banking facilities for the export, Exporters India Ltd. May get the credit transferred to the manufacturers.

Check Your Progress

4. In transferable credit, the exporter has the right to make the credit available to

_____

A credit is transferred in the following ways: The exporter, now called the first beneficiary, will apply to the negotiating bank (intermediary bank) to transfer and establish in favour of the manufacturer (the second beneficiary) a letter of credit with the same terms and conditions as that of the original with the exception to the following:

The amount of the credit may be reduced. The difference would be the profit or commission on the transaction for the first beneficiary.

The validity period and date of shipment may be curtailed. For example, if the original letter of credit has 12th May as the latest date of shipment and 18th May, respectively. The difference in time would be required by the first beneficiary to substitute his invoices of those submitted by the second beneficiary.

Because the value of goods is reduced, the percentage for which insurance cover must be affected may be increased in such a way as to provide the amount of cover stipulated in the original credit.

The negotiating bank will obtain the original credit and endorse the fact of transfer on it. It will then issue a credit in favour of the second beneficiary complying with the first beneficiary. The credit would show the first beneficiary as the applicant. This is done so as not to reveal the name of the importer to the second beneficiary. But if the name of the applicant for the credit is specifically required by the original credit to appear in any document other than the invoice such requirement must be fulfilled. When the second beneficiary ships and presents documents to the bank, the amount as per the credit in his favour is paid to him. The invoice of the first beneficiary is then substituted and the difference in the amount paid to him.

If the first beneficiary fails to supply his own invoice of first demand by the negotiating bank, he has the right to deliver to the issuing bank the documents, including the invoice, submitted by the second beneficiary.

As an alternative to the above arrangement, the first beneficiary may collect his commission directly from the second beneficiary and the transfer may be made for the full amount of the credit. In such cases normally no substitution of invoices by the first beneficiary is needed.

The first beneficiary may request that payment or negotiation be effected to the second beneficiary at the place to which the credit has been transferred up to and including the expiry date of the credit unless, the original credit expressly states that it may not be made available for payment or negotiation at place other than that stipulated in the credit. This is without prejudice to the first beneficiary"s right to substitute

subsequently his own invoices and drafts for those of the second beneficiaries and to claim any difference due to him.

Transfer of a credit is allowed only once. It may be transferred in full. For example, a letter of credit in favour of A for US$ 20,000 may be transferred to B for US$ 20,000. Of, it may be transferred in fractions up to the full limit of the credit provided partial shipments are not prohibited. In our example, the credit may be transferred to B for US$ 5,000 and to C for US$ 7,000 and balance of US$ 8,000 may be retained by A. But no second transfer is allowed. Therefore, C cannot further transfer it do D.

A credit can be transferred only if it is expressly designated as transferable by the issuing bank. Terms such as „divisible", „fraction able", „assignable" and „transmissible" to not render the credit transferable. If such terms are used they shall be disregarded [Article 48(b)].

Who can affect the transfer? In case of payment credit or acceptance credit, the paying bank or the accepting bank, as the case may be, is authorized to affect the transfer. In the case of a freely negotiable credit, transfer can be affected by the bank specifically authorized in the credit as a transferring bank.

The transferring bank shall be under no obligation to affect such transfer except to the extent and in the manner expressly consented to by such bank. However, the credit can be transferred only on the terms and conditions specified in the original credit except in respect of amount, period of validity, insurance, etc., as detailed above.

At the time of making a request for transfer and prior to transfer of credit, the first beneficiary must irrevocably instruct the transferring bank whether or not the right to refuse to allow the transferring bank to advise amendments to the second beneficiary(i.e.). If the transferring bank consents to the transfer under these conditions, it must, at the time of transfer, advice the second beneficiary (i.e.) of the first beneficiary"s instructions regarding amendments.

If a credit is transferred to more than one, second beneficiary refusal of an amendment by one or more of them does to invalidate the acceptance by the other second

beneficiary with respect to whom the credit will be amended accordingly. With respect to the second beneficiary who rejected the amendment, the credit will remain unamended.

Bank changes in respect of transfers are payable by the first beneficiary unless otherwise specified. The transferring bank shall be under no obligation to effect the transfer until such charges are paid.

Under CPC, the transferable credits are governed by Article 48. The salient features of the lengthy Article are included in the above discussion.

3.9 BACK – TO BACK CREDITS

Where the beneficiary under a letter of credit is an intermediary procuring goods from suppliers and likes the suppliers to get the benefit under the credit, it is done by transferring the credit in favour of the suppliers. But transfer of the credit is possible only if it is authorized by the credit itself. The problems is solved by the beneficiary requiring his bank (who may or may not be the intermediary bank for the credit) to open another letter in favour of the supplier on the original credit. Such an ancillary letter of credit is known as the „back – to – back credit" or „countervailing credit" or credit and counter credit".

A back – to – back letter of credit is often an inland letter of credit. It is different from the original expect credit expect that the original credit forms the security based on which the bank undertakes the risk under the back – to – back credit. The supplier (beneficiary of the back – to back credit) ships goods to the importer or supplies goods to the exporter and presents the documents t the bank as is specified in the credit. It is intended that the exporter would substitute his own documents and ship goods for to the importer, if necessary, and present documents for negotiation under the original credit. His liability under the back – to – back credit would be adjusted out of these proceeds.

The following points may be kept in mind by the bank while opening a back-to-back while opening a back-to-back credit:

The terms and conditions of the back-to-back credit should be exactly as that of original letter of credit except for curtailment in:

The amount of credit. This leave margin of profit for the exporter; and the validity and shipment dates. This would leave sufficient time for the exporter to prepare and substitute his documents and arrange for shipment to importer if the goods are supplied by the supplied by the supplier to him. Only then the bank can get reimbursement under the original credit.

Though it is not necessary that only an intermediary bank under the original credit should open back-to-back credit, it would be better that such credits are opened only where the bank is also a negotiating bank. This would avoid the risk of the documents substituted by the exporter being rejected by the negotiating bank as not fulfilling the conditions of the credit.

The original credit should be an irrevocable credit.

A back-to-back credit has certain features in common with a transferable credit. Under both, the benefit under the credit is transferred to a third party. The documents are substituted by the first beneficiary under both types of credits. The possibility of the importer knowing the real supplier or vice versa is avoided in both cases.

But a back-to-back credit differs from a transferable credit in the following respects:

There is an authority from the issuing bank for the transfer of benefit under the credit in the case of a transferable credit. No such authority is there under a back-to-back credit.

In a transferable credit the second credit is only an extension of the first credit. A bank-to-back credit has an existence independent of the original.

Following from the above, under the transferable credit the negotiating bank can submit the documents submitted by the second beneficiary to the issuing bank in case the first beneficiary fails to submit his own documents (i.e., invoice etc.) on first demand bay

the negotiating bank. Under a back-to-back credit submission of documents submitted by the second beneficiary is not possible.

NOTES

3.10 RED CLAUSE AND GREEN CLAUSE CREDITS

Also known as „packing" or „anticipatory" credit a red clause letter ofcredit contains a clause printed in red, authorising the negotiating bank to grant advances to the exporter for the purchase and processing, packing and arranging for movement of goods up to the port for shipment. The advance, with interest and other charges, is recoverable from the bills that would be tendered under the letter of credit and only the balance would be paid to the exporter.

The amount of the advance should be less than the amount of the letter of credit so that it remains fully secured by the obligation of the opening bank. The opening bank remains liable for the advance. If the exported does not tender bills by the expiry date of credit, the bank should serve a notice on the exporter and also intimate the opening bank. If the advance fails the opening bank should reimburse the bank which has mad the advance. The opening bank can recover the amount from the importer on whose request the credit has been established.

Check Your Progress

5. Red clause letter of credit is known as contains____.

The negotiating bank is not required to supervise the utilization of the advance. Mere declaration from the exporter that he would be utilizing the funds for the exporters under the credit would be sufficient. But the bank should see that the stipulations, if any, in the credit regarding the advances are scrupulously followed.

At the time of advising the credit and advancing under the credit the bank should take the following precautions:

The credit rating of the issuing bank should be verified. It should be kept in mind that in case the advance fails recourse has to be had to the issuing bank.

If the credit requires certain documents to be taken or goods to be charged in favour to the bank or drafts to be obtained on the issuing bank, such formalities should be completed before the advance is made.

If the beneficiary is not its customer, identification of the borrower is necessary before the advance is made. A report from the beneficiary"s bank may be obtained.

To cover exchange fluctuations the borrower may be advised to book a forward contract for the amount of the credit. This would help keep the advance granted fully covered by the amount of the credit. The amount of advance should be less than the amount of the credit.

An undertaking that he would tender documents under the credit before the due date should be obtained from the beneficiary.

An extension of the red clause credit is the green clause credit which not only permits preshipment advances but also covers storage in the name of the bank.

Both red and green clause credits and used extensively in Australia wool trade.

Check Your Progress

6 Define Standby credit.

3.3.9 Standby or Guarantee Credits

The US comptroller of Currency define a standby letter of credit thus: "A standby letter of credit is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer: to repay money borrowed by or advanced to for the account of the party; or to make payment on account of any indebtedness undertaking by the account party; or to make payment on account of any default by the account party in performance of an obligation.

Under a standby credit, also known as guarantee credit, the issuing bank assures the beneficiary that in the event of non-performance or non-payment of an obligation by the applicant, the beneficiary may get the payment from the issuing bank. The claim should be a draft accompanied by the requisite documentary evidence of non-performance as stipulated in the credit;

Standby credit is a substitute for bank guarantee and is used in countries where issuing of bank guarantee is not allowed, e.g., Japan and the USA.

Modus Operandi of L/C

The use of a letter of credit in financing international trade may be illustrated with the following example:

Suppose a US-based wants to purchase goods from an India seller, suppose, further, that the India exporter, instead of drawing directly on the US importer, requests him to arrange an irrevocable confirmed letter of credit. The US importer then applies to his bank in the USA t issue an L/C. In his application for the L/C to the bank, the importer will set forth the terms of sale and will mention the documents which shall accompany the draft, the usance, the final date of shipment, etc. if the bank is prepared to issue the credit, the importer will sign the L/C contract, in which he will agreed to reimburse the bank for all outlays and to give such security as the bank demands.

The issuing bank will now notify its correspondent bank in the exporter"s place and will request the latter of confirm the credit to the exporter. The notifying bank will now inform the exporter that an irrevocable and confirmed letter of credit has been arranged, and will describe the terms under which the shipment must be made before the draft is honoured. This will make the contract binding on both the issuing bank and the confirming bank.

The exporter will now ship the goods to the US buyer, draw a time draft on the issuing bank and may still sell the draft with documents attached to his own bank in India. The Indian bank will mail the draft and documents to its own correspondent bank in the USA which, in turn, will present it to the drawee bank for acceptance. The accepting bank will deliver the documents to the importer, usually against a trust receipt, an instrument under which the bank retains title to the merchandise.

3.12 BILL OF EXCHANGE

Definition

A bill of exchange is an instruction by the exporter (drawer) to the importer or the importer"s bank to make payment of the amount mentioned in it. A bill of exchange is a

negotiable instrument and is governed by the Negotiable Instruments Act in India and by similar enactments in other countries. The Negotiable Instruments Act defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of instrument".

The bill, under a letter of credit, may be drawn on the issuing bank or another drawee bank but not on the importer. If the credit nevertheless calls for a bill on the applicant, banks will consider such bills as additional documents [Article 9 (a) (IV)].

Types of Bills

Sight and Usance Bills

A bill of exchange is a sight bill (or demand bill) if the drawee is to make payment immediately on presentation of the bill to him. A bill is a usance bill if the drawee is to make payment after a period specified (say, 30 days or 60 days) in the bill has expired. A usance bill may be „after date" bill or „after sight" bill. Foran „after date" bill, the due date is calculated from the date appearing on the face of the bill. This may also be drawn „after so many days from date of bill of lading or airway bill" in which case the due date will be calculated from the date appearing on the relevant bill of lading or airway bill. For an „after sight" bill, the date is calculated from the date it is sighted, i.e., it is accepted by the drawee.

In some countries, including India, for all usance bills, a grace period of three days is available. That is, the bill becomes payable three days after the due date calculated as per the usance of the bill.

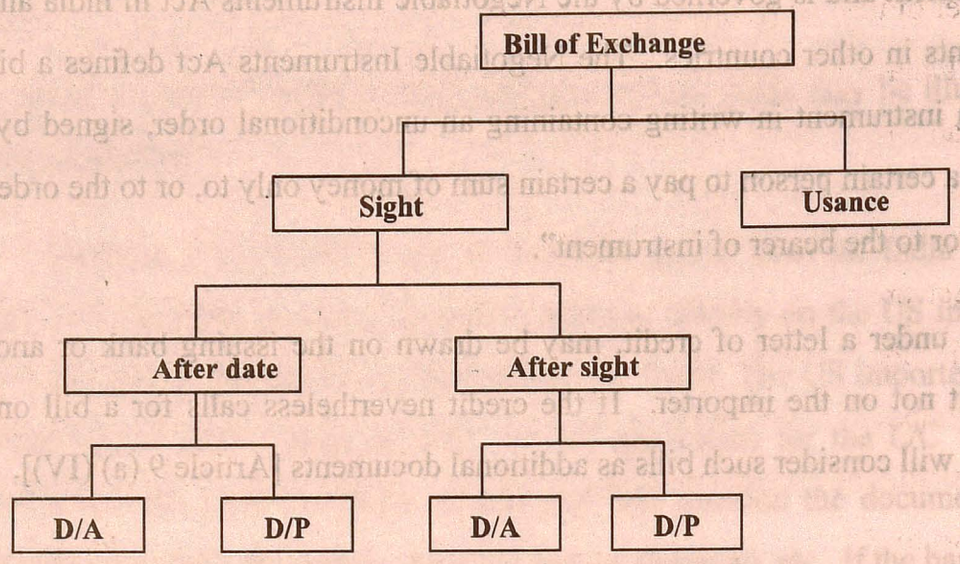


Fig: Types of Bills of Exchange

D/A and D/P Bills

A usance bill may be on D/A or D/P terms. If is on D/A ter ms (documents against acceptance) the collecting bank is deliver the documents to the drawee on the acceptance of the bill by him. The payment will be made by the drawee on the due date of bill. For the period from the date of acceptance to the date of payment, the bank remains unsecured. If it is a D/P bill (documents against payment), the documents will be delivered to the drawee only on payment till which time they are retained by the bank. So the bank retains control over goods till payment is received.

It may be noted that whether the bill is D/A bill or D/P bill may or may not appear on the bill. The indication this to this effect will be found in the instructions of the drawer to the bank.

Inland and Foreign Bills

According to negotiable Instruments Act, a bill which is drawn in India and made payable in of drawn upon any person in India is an inland bill. Thus an inland bill must fulfill both the conditions that (i) it is drawn in India, and (ii) it is payable in India or drawn on a person resident in India (even though payable abroad). Any bill which does

not fulfill either of the conditions is a foreign bill. Thus a bill drawn in India, payable at a place outside India by a person resident outside India and a bill drawn at a place outside India, but payable in India are foreign bills.

Foreign bills are normally drawn in sets. Section 132 of the Negotiable instruments Act provides: "Bills of Exchange may be drawn in parts, each part being numbered and containing provision that it shall continue payable only so long as the others remain unpaid. All the parts together make a set; but the whole set constitutes only one bill, is extinguished when one of the party, if a separate bill, would be extinguished. "The exception to this section sates that "When a person accepts or endorses different parts of the bill in favour of different person, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill">

Normally bills are drawn in sets of two copies. Either of the copies can be presented to the drawee for payment or acceptance. Once payment or acceptance is made on one copy, the other becomes null and void.

In international dealings, not only bills of exchange, but other documents are also prepared multiple copies. The documents are sent in two sets, by separate mail for each set. The first set is sent on one day and the second set may be sent on the subsequent day. The procedure is to avoid risk of delay/loss of documents in transit.

Noting and Protest

When a bill is dishonored, steps should be taken to get it noted and protested. Nothing and protesting by the Notary Public serves as an authentic proof of the fact of dishonour of the bill.

Noting should be done within a reasonable time of dishonour. For noting, the dishonoured bill is again presented formally by the notary himself or by his clerk or, where authorized by an agreement or usage, by a registered letter. When acceptance or payment is refused he makes a note on the instrument. The note should contain the particulars of the fact of dishonour, or, if the instrument has not been expressly dishonoured, the reason why the holder treats it as dishonoured and the notary"s charges.

Protest is a step ahead of noting. It contains, in he from of a legal document, the fact of dishonour and all other related facts. Under Negotiable Instruments Act, when a bill is required to be protested within a specified time or before some further proceeding is taken,, it is sufficient that the bill has been noted for protest before the expiration of the specified time or the taking of the proceedings and the formal protest may be extended at any time therefore as of the date of noting.

Foreign bills of exchange must be protested for dishonour, when such protest is required by the law of the place where they are drawn.

Stamp Duty

A bill of exchange issued in India will bear stamp duty according to the rates prescribed in the Indian Stamp Act. Sight bills and bills with usance up t 90 days are exempt from stamp duty. Usance bills for periods beyond 90 days are to be stamped at the rate of Rs.1.25 per Rs.1, 000 per quarter. Whether the bills drawn in India will attract stamp duty at the place of payment will depend upon local law prevalent there.

When a usance foreign bill is received into India, it has to be affixed with the stamp duty as per the Indian Stamp Act, irrespective of the duty paid abroad. It should be stamped even though it was originally stamped in India. The amount of the bill, if expressed in foreign currency, should be converted into Indian rupees by applying the rate of exchange prevalent on the date of the bill. The rate of exchange for different currencies for this purpose announced by the government is circulated periodically to banks by FEDAI. For this rupee value, the bill should be appropriately stamped, before it is presented to the drawee for acceptance. The stamp to be affixed is the special adhesive stamp with the words „Foreign Bill" printed on it.

Letter of Credit and financing of Foreign Trade

A letter of credit is an undertaking by a bank to pay or to arrange to pay for specified merchandise, provided that certain stipulated conditions are met by the beneficiary. The international Chamber of Commerce has defined a banker"s documentary credit as „ an arrangement, however named or described, whereby a bank

(the issuing bank), acting at the request and in accordance with the instructions of a customer (the applicant to the credit), to make payment to or to the order of a third party (the beneficiary)m or is to pay, accept to negotiate bills of exchange (drafts) drawn by the beneficiary, or authorize such payments to be mad or such drafts to be paid, accepted or negotiated by another bank, against stipulated documents and compliance with stipulated terms and conditions".

The letter of credit arrangement offers advantages to both the seller and buyers. As far as the seller is concerned, a letter of credit ensures him payment for the goods he sells, provided, of course, the follows the instructions. Tough the buyers has have the botheration of arranging for the letter of credit, it may enable him to obtain more liberal discounts and a lower price from the seller. Further, the buyer is assured that the shipment will be made by the date specified in the letter of credit, it may enable him to obtain more liberal discounts and a lower price from the seller. Further, the buyer is assured that the shipment will be made by the date specified in the letter of credit, or else the credit will be made by the date specified in the letter of credit, or else the credit will expire.

Parties to the Letter of Credit

The opener: The opener is the buyer (the importer). The letter of credit is opened at the initiative and request of the buyer.

The Issuer: the issuer, also called the opening or issuing bank, is the bank in the importer"s country issuing the letter of credit at the request of the importer.

The Beneficiary: The beneficiary is the party in whose favour the credit is issued: that is the beneficiary is the seller or exporter.

The three parties mentioned above are regarded as the fundamental parties to a letter of credit. However, the following parities are concerned with a letter of credit transaction.

The confirming Bank

The confirming bank is a bank in the exporter"s country which guarantees the credit at the request of the issuing bank. The confirming bank undertakes all the obligations of the issuing bank as a primary party to the credit, and even if the issuing bank fails during the currency of the credit the confirming bank is obliges to honour its commitment.

The Notifying Bank

The notifying bank is the which, at the request of the issuing bank, notifies the beneficiary that the credit has been opened in his favour. If the letter if the of credit is confirmed, the confirming bank advises the beneficiary accordingly.

The Paying Bank

The paying bank is the bank on which the draft or bill of the exchange is to be drawn under the commercial credit. The paying bank may be the issuing bank, the conforming bank or the notifying bank.

The Negotiating Bank

The negotiating bank is the bank which pays or accepts the drafts of the exporter. If no paying bank is specified in the credit the beneficiary may to any bank and present the draft and related documents under the credit; and if the bank agrees to negotiate the documents, it becomes the negotiating bank. By negotiation drafts, the negotiation bank becomes „an endorsee and bonafide holder" of the draft and has recourse on the drawer of the bill until it is accepted and paid by the drawer.

3.13 FINANCINE FOREIGN TRADE

The statutory basis for regulation of exports form India is the Foreign Trade (Development and Regulation) Act, 1992 which has replaced the import and Exports (control) Act, 1947. The Government is empowered to ban the export of certain goods

from India and/or restrict export in quantity, value, etc., by subjecting them to licensing procedures.

In exercise of the powers conferred under Section 30 of the Act, the Central Government has notified the Export and Import Policy valid for a period of five years, 1st April 1997 to 31st march 2002. During the currency of the policy, the Central Government may make any amendments to it. Such amendments will be published by means of Public notices issued by the Director General of Foreign Trade.

Items subject to export regulation are included in the Negative List of Exports attached to the Export and Import Policy. Exports of goods other than those in the negative list can be done freely.

The negative list of exports consists of three parts as follows:

items export of which is prohibited (prohibited items);

items export of which is subject to licensing (restricted items);

items, export of which can be done only through the specified canalizing agencies (canalized items).

3.14 ROLE OF COMMERCIAL BANK

All the financial requirements of an exporter, form the time he enters into a sale contract and starts working on it and till he receives final payment from the importer, are met by commercial banks. The facilities available from banks are generally divided into two broad heads: (i) Pre-shipment Finance, and (ii) Post-shipment Finance.

(i) Pre-shipment Finance or packing credit is the advance granted to the exporter to process, manufacture, pack and prepare the goods for export. In other words, it is the facility extended to the exporter before and till the goods are shipped for export.

(ii) Post-shipment Finance refer to the credit facilities extended to the exporter from the goods are shipped and till the export proceeds are realized. Post-shipment finance may take any of the following forms:

Negotiation of a bill drawn under a letter of credit:

Purchase of bill not drawn under a letter of credit;

Advance against bill sent for collection; and

Advance ageist export incentives like duty drawback.

Advances at the pre-shipment stage are discussed in this chapter and those at post-shipment stage in the next chapter.

3.15 SUMMARY

Thus this chapter reveals the various kinds of letter of credit which are used in international trade. Also, it clearly depicts the bill of exchange and the various types of bills used for settlements.

3.16 Key words used in the lesson

Letter of credit

Bill of exchange

3.17 Answers to check your progress question

1 Sight draft

2 Issuing bank

3 Revolving

4 Third parties

5 Packing or anticipatory credit

6 The US comptroller of Currency define a standby letter of credit : "A standby letter of credit is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer: to repay money borrowed by or advanced to for the account of the party; or to make payment on account of any indebtedness undertaking by the account party; or to make payment on account of any default by the account party in performance of an obligation.

3.18 Model questions

1. Define Letter of credit.
2. What is acceptance credit?
3. What do you understand by Revocable and irrevocable letter of credit?
4. Define Bill of exchange.
5. Name the parties for the letter of credit.

Essay questions:

1. Examine the various kinds of letter of credit used in international trade.
2. Enumerate the different kinds of bill according to negotiable instruments.

3.19 Further reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

NOTES

UNIT – 4

PRE-SHIPMENT AND POST-SHIPMENT CREDIT

UNIT STRUCTURE

4.1 Introduction

4.2 Unit Objectives

4.3. Pre-shipment credit in foreign currency

4.4. Packing credit advances

4.5 Type of account in packing credit

4.6. Post-shipment credit

4.7 Advances against duty drawback

4.8 Financing Exports

4.9 Other services to exporters

4.10 Summary

4.11 Key words used in the lesson

4.12 Answers to check your progress questions

4.13 Model Questions

4.14 Further reading

4.1 INTRODUCTION:

Pre-shipment credit and post-shipment credit in a foreign currency (PCFC) exporter are allowed to avail credit in a convertible currency. In this unit, we can elaborately discuss the procedures followed in availing the above credits.

4.2 UNIT OBJECTIVES

1. to understand the procedures adopted in making payment through pre and post shipment credit.
2. To know the eligibility conditions for packing credit

4.3. PRE-SHIPMENT CREDIT IN FOREIGN CURRENCY

(PCFC) exporters are allowed to avail pre-shipment credit in a convertible currency at interest rates not exceeding 2% over 6 months Lower plus withholding tax. The credit will be self liquidating in nature and will be adjusted by discounting the relative export bill designated in foreign currency.

The banks which lend under the scheme may use balance available in EEFC, Resident foreign Currency Accounts. FCNR (B) Accounts and foreign currency balance available in Escrow accounts. Or, it may raise lines of credit abroad at a cost not exceeding 6 months Libo rate plus 1%.

Check Your Progress

1 Under the Pre-shipment credit in a foreign currency, the credit under the scheme is available for a maximum period of _____ days.

The credit under the scheme is available for a maximum period of 180 days. If

Libo rate is around 6% p.a. for meaning of the term please see Chapter 33 on Eurocurrency Markets.

Escrow account is the modern currency account opened under a 'counter trade' arrangement Counter trade is the modern version of barter trade. A counter trade agreement is voluntarily entered into between an Indian party, whereby the value of goods imported into India is adjusted against the value of exports from India extended beyond this period, 2% penal interest is changed. If the PCFC is not adjusted within 360 days, it will be adjusted at the TT selling rate for the currency concerned and will be treated as a rupee advance.

PCFC can be extended in one convertible currency in respect of an export order invoiced in another convertible currency. For instance, an exporter can avail of PCFC in

NOTES

US dollar against an export order invoiced in Deutsche mark. The risk and cost of cross currency transaction will be that of the exporter.

In case of HPS groundnuts and oil extracts packing credit can be granted higher than the FOB value, the excess to be adjusted within 30 days of export. For these commodities packing credit can be granted both in rupees and in foreign currency, restricting the PCFC only to the portion to be exported.

Apart from the lower interest rate, the major advantages under PCFC are cover from exchange risk (due to fluctuation in exchange rates) and cost of buying and selling the same foreign currency from the bank, provided the facility is used for imports and the imports and the imports are invoiced in the same currency as export under the order. For instance, if the export order is for USD 1, 00,000 and 60,000 the liability will be adjusted by his submission of a bill in US dollars. If he avails rupee packing credit, on imports bank will apply the bill selling rate and for the export bill submitted bill buying rate. Under PCFCA on USD 60,000 no conversion is involved. The exporter saves the differences between the buying and selling rates for dollar. Further he is insulated form fluctuations in the exchange rate between dollar and rupee.

PCFC may be also be availed in rupees towards local payments for materials, labour, etc. In the case the liability of the exporter will be designated in the foreign exchange by applying the ruling TT selling rate;

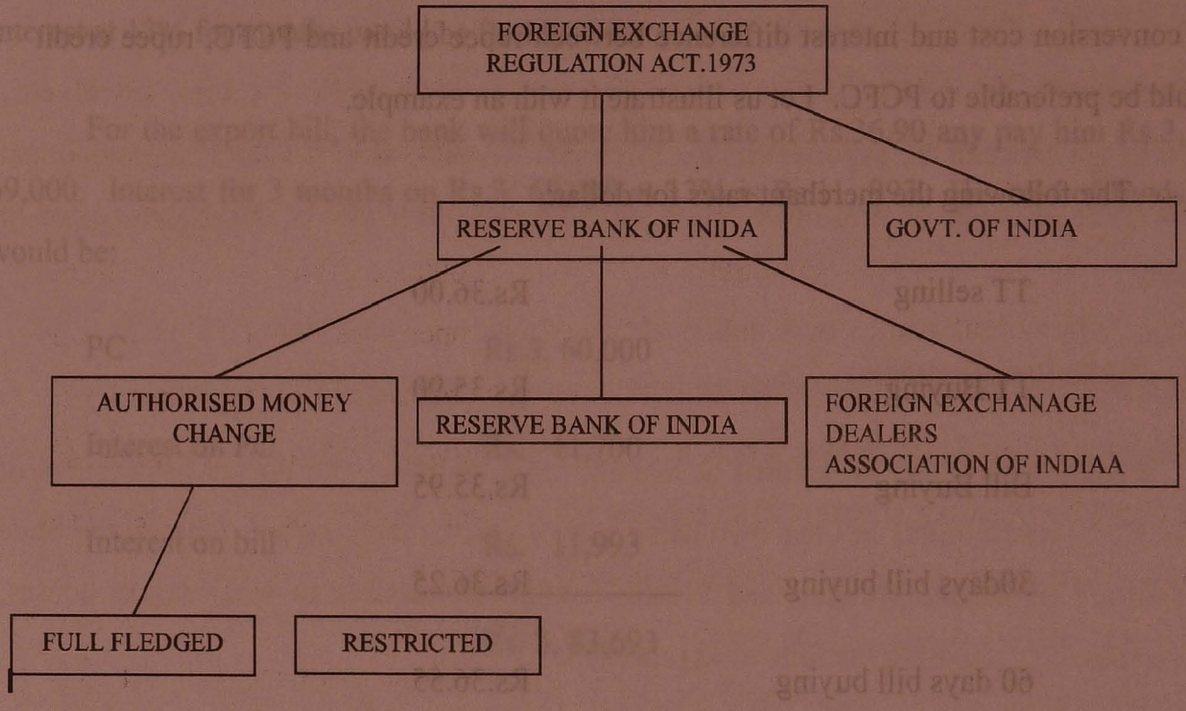
If PCFC has been availed by the exporter against an export order, the export bill drawn under that will have to be discounted with the bank under the Export Bills Discounting Scheme. PCFC will be adjusted by discounting the bill. Interest at Libo rate plus 2% is charged on the bill thus discounted. The bank will realize the bill in foreign currency and adjust the foreign currency liability under Export Bills Discounted account. The balance, if any, will be converted at the ruling. TT buying rate and paid to the exporter.

Other conditions and eligibility are similar to that packing credit in rupees.

Forward Cover for PCFC:

NOTES

No exchange risk is involved if the PCFC is availed in the same foreign currency as the invoice. If the invoice is in India.



Check Your Progress

2 Foreign Exchange Regulation Act was passed in the year _____

On availing of PCFC, the contract should be cancelled at prevailing market rates to the extent of the PCFC drawl used for payment toward imported inputs in foreign currency.

PCFC When Advantageous

Apparently PCFC is advantageous as compared to the rupee packing credit due to interest differential and avoidance of conversion cost. But this advantage will accrue to the exporter only so long as the gain thus made is not offset by the premium he loses on dollar for the bill under the export contract.

Where PCFC is availed, the export bill tendered will be discounted under the export bill discounting scheme and no conversion into rupee, in involved. In case the

exporter had availed rupee packing credit, for the export bill tendered, the bank will apply the bill buying rate. The bill buying rate applied will have an built in premium for the transit and usance period which is not available to the exporter when he avails PCFC.

The actual financial cost to the exporter under PCFC remains the same as the interest paid by him on PCFC. If he avails rupee packing credit, the total financial cost would be the interest paid, plus conversion cost (difference between buying and selling rates), less the premium on forward dollar. If the premium gained is more than offset by the conversion cost and interest difference between rupee credit and PCFC, rupee credit would be preferable to PCFC. Let us illustrate it with an example.

The following the merchant rates for dollar:

TT selling	Rs.36.00
TT Buying	Rs.35.90
Bill Buying	Rs.35.95
30days bill buying	Rs.36.25
60 days bill buying	Rs.36.55
90 days bill buying	Rs.36.90

Interest on PCFC and on Export Bill discounting is 9% p.a

Interest on Rupees packing credit and rupee post shipment credit is 13% p.a

For simplicity sake, we assume the dollar – rupee rates to remain the same throughout the transaction.

PCFC if the exporter avails PCFC of USD 10,000 for 3 months and adjusts it by export bill for equivalent amount, drawn payable 3 months from bill of lading, his cost would be as under:

PCFC interest at 9% for 3 months	=	USD 225
On export bill discounted at 9% for 3 months	=	USD 225
	=	USD 450

Converted at the TT selling rat of Rs.36.00, the rupee cost is Rs.16.200.

Rupee PC, if the exporter avails equivalent amount in rupees (Rs.3, 69,000), interest at 13% for months would be Rs.11, 700.

For the export bill, the bank will quote him a rate of Rs.36.90 any pay him Rs.3, 69,000. Interest for 3 months on Rs.3, 69,000 at 13% is Rs.11, 993. His cost of funds would be:

PC	Rs.3, 60,000
Interest on PC	Rs. 11,700
Interest on bill	Rs. 11,993
	Rs. 3, 83,693
Less: Export bill	Rs. 3, 69,000
Cost of funds	Rs. 14,693

Availing of rupee packing credit turns out to be cheaper in this case.

Check Your Progress

3 What is pre-shipment credit of packing credit?

4.4 PACKING CREDIT ADVANCES

Definition

A pre-shipment credit of packing credit is any loan of advance granted to an exporter for financing the purchase, processing, manufacturing or pacing of goods for export.

Eligibility

(a) Direct Exports

The pre-shipment credit can be granted to bono fide exporters generally on this strength of letter of credit established by banks of standing abroad in favour of the exporter. If no letter of credit has been established, the credit can be granted on the strength of a firm order. The bank should ensure that the letter of credit or the firm order is lodged with it. In case the exporter is not able to lodge the letter or firm order immediately, the packing credit may be granted on the strength of cables, letters, etc., exchange between the exporter and the importer. In such cases, it should be ensured that the letter of credit or firm order is lodged by the exporter after a reasonable period of time.

(b) Indirect Exports

Check Your Progress

4 The export house should open inland letter of credit in favour of the

Packing credit can be granted to manufacturers/supplier who do not have letters of credit or export orders in their own name and ae routing their exports through the State Trading Corporation/Minerals and Metals Trading Corporation or other export houses, agencies, etc., adopting the following procedure:

(i) The export house should issue a letter setting out the details of the export order and the portion thereof to be executed by the manufacturer and also certifying that the export house has not obtained and will not ask for packing credit facility in respect of such portion of the order as is to the executed by the manufacturer.

(ii) The export house should open inland letter of credit in favour of the supplier giving relevant particulars of the export letter of credit/order and the outstanding in the packing credit account is should be extinguished by negotiation of bills under such an inland of credit. If it is inconvenient for the export house to open such an inland letter of credit in favour of the manufacturer, the latter should draw bills on the export house in respect of the goods supplied for export and adjust

packing credit advance from the proceeds of such bills. In case the bills drawn under such arrangement are not accompanied by bills of landing or other export documents, the bank should obtain through the manufacturer/supplier a certificate from the export house at the end of each quarter that the goods supplied under this arrangement have in fact been exported.

(iii) The manufactures should give an undertaking that the advance payment, if any, received from the export house against the export order would be credited to the packing credit account.

C.Sub-suppliers

Packing credit can be granted to sub-suppliers of raw materials, components of exported goods, on the basis of the inland letter of credit opened in favour of the supplier by the exporter concerned. On supply made by the supplier to the exporter, the exporter's bank will pay the supplier and absorb the amount in the packing credit account of the exporter the scheme covers only the first stage of production cycle, i.e., a manufacturer exporter will be allowed to open inland letter of credit only in favour of his immediate supplier of raw material, component, etc. It will not be extended to suppliers of materials to such immediate suppliers.

Export processing units/export processing zone units supplying goods to another EOU/EPZ unit for export purpose are also eligible for packing credit.

(c) Deemed Export

Packing credit can be extended to parties against orders for supplies to projects by multilateral or bilateral agencies/funds (such as IBRD, ADB, OPEC) which is recognized as deemed export under the Export Import Policy provided:

(i) The advance will be adjusted from free foreign exchange representing payments for the supplies of goods mad under the order of the agency/fund. However, in certain cases free foreign exchange may be

placed at the disposal of a Central Agency of the Government of India like the Central Water and Power Commission. The supplier of goods is not directly concerned with the receipt of foreign exchange. Packing credit may be granted on the basis of an authenticated copy of the contract between the project authorities and the supplier, togther with a certificate issued by the concerned Central Agency to the party to the effect that he has won a particular tender under international competitive bidding for supplies to such aided project in India.

(ii) The supplies mad by the Indian suppliers are used by the agency/fund only for its aided projects/programmes in India and are eligible for the grant of normal export benefits by the Government of India.

4.5 TYPE OF ACCOUNT

Normally, packing credit will be extended in the form of loan account, a separate account being maintained for each export order. The request from the party should be supported by lodgment of letter of credit or firm order as mentioned in (a) under 'Eligibility' above. However, depending upon the merits of the case, banks may extend packing credits a running account (i.e., single case credit account for all export orders) and also waive the condition of prior lodgment of letter of credit/firm order, provided the following conditions are fulfilled:

(i) the need for 'running account' facility has been established by the exporter to the satisfaction of the bank

(ii) the exporter's track record continues to be good;

(iii) the letter of credit/firm order should be produced within 30 days;

The pacing credit account should be maintained separately and not mixed with normal current account of cash credit account of the customer.

Period of Loan and Internet

The period for which a packing credit may be granted depends upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing and shipping the related goods. But, as a general guidance, it should not exceed 180 days. If the exporter requires extension of period of advance, the bank may grant it taking into account the circumstances of the case. In exceptional cases, the bank may also consider grading packing credit for periods up to 270 days above.

Currently, interest is chargeable at 12% for period up to 180 days and at 14% for period beyond 180 days and up to 270 days provided the bank agrees for extension. Concessional interest is not available beyond 270 days in any case and beyond 180 days where extension is not sought by the exporter or it is denied by the bank. If the advance is not adjusted within 360 days, domestic rate plus 2% is chargeable from days one of advance.

Where the export h house and the supplier/manufacturer avail the packing credit for the same order, the period for which the concessional rate of interest it available may be apportioned between the two. For example, pre-shipment finance at 13% p.a. may be made available to the supplier for 90 days and to the export house for the balance of 90 days.

The concessional rates of interest and the periods for which they are available are determined by the Reserve Bank.

Quantum of Advance

Normally the amount advanced as pre-shipment finance should not exceed the FOB price or the domestic cost of production whichever is lesser. Margin may also be stipulated depending upon the party's worth and the commodity to be exported. If the letter of credit or firm order is on CIF/CFR basis, the value should be reduced to FOB value and finance eligible should be calculated on that value.

Advance exceeding the FOB value, but up to the domestic cost of production, can be made in case the commodity is eligible for duty drawback and the advance is covered by Export Production Finance Guarantee of ECGC. As soon as the shipment is made, the bill amount should be adjusted towards the packing credit account and any balance in the account should be treated as a post-shipment finance to be adjusted out of duty drawback to be received later.

Advance exceeding the FOB value, but up to the raw material cost, can also be made in the case of export of HPS groundnuts and deoiled/defatted cakes. The excess is to be adjusted out of duty drawback to be received later.

If the exporter has an intention of transferring funds to his EEFC account out of exports under a letter of credit or firm order, packing credit can be granted only for the balance amount.

Source of Repayment

The packing credit account should be repaid out of the proceeds of foreign bills of exchange drawn under the export contract. It may also be repaid out of export incentives like duty drawbacks.

Substitution of contract, in case the exporter is not able to export against the original contract due to reasons beyond his control, the packing credit may be adjusted by negotiating export bills relating to another contract, provided the goods financed against are exported under the substituted contract within a reasonable time.

Substitution of commodity/fresh exporter with good track record, banks may:

Permit liquidation of packing credit by exporting some other commodity where it becomes commercially necessary and unavoidable; and

Mark of the existing packing credit with export proceed of documents

Again which no packing credit has been drawn by the exporter.

The relaxation is not be extended to transactions of sister/associate/group concerns. Banks should ensure that the exporter has not availed of packing credit from another bank against the documents submitted. Banks should also satisfy themselves about the valid reasons as to why packing credit extended for shipment of a particular commodity cannot be liquidated by the normal method.

Rupee payment, if the export cannot take place at all, the account may be adjusted out of local funds. But interest at domestic rate plus 2% should be charged on the account from the date of advance.

Appraisal

Packing credit is to be adjusted out of the export bills tendered by the borrower on shipment of goods. Therefore, the packing credit limit should be considered along with limit for purchase of foreign bills.

The normal credit appraisal norms used by the bank are applied in the case of grant of packing credit also. The bank has to decide on the basis of the borrower's character, capital, etc., besides his experience in export. In addition, the bank should judge if export would take place. This entails enquiring into if exchange control regulations have been or will be fulfilled.

The applicant has an importer – exporter code number allotted by the Regional Trade Control authorities.

The exporter's name is not in the exporter's caution list of Reserve Bank.

The goods to be exported are not banned for export.

The letter of credit/firm order provides all essential details like the type and quality of goods to be exported, price, quantity, shipment date, etc. They do not violate any of our exchange control regulations relating to terms method of payments.

There is sufficient time allowed in the letter of credit/firm order to enable the exporter to manufacture the goods and export them.

The country to which exports are to be made is not under political or economic stress, which may delay remittance of foreign exchange by the country. ECGC may help in getting information in this regard.

If the letter of credit is restricted to some other bank, the exporter gives an undertaking to route the bills through the bank making the advance.

Conduct of Account

Separate loan account should be maintained for each export contract unless it is decided to grant the running account facility. The loan should be disbursed in stages depending upon the requirements of the exporter. Lump sum disbursement disregarding the actual requirement for the purpose of the loan should be discouraged.

All the goods that are purchased out of the loan are either hypothecated or pledged to the bank. Thus packing credit may be secured by hypothecation or pledge of goods. But sometimes the credit may remain a clean advance also. This may be the case where payment is to be made in advance for procurement of required materials or where payment is made for services.

Where the packing credit is in the form of cash credit account, the bank should see that the operations in the account are confined only to export transactions. All export proceeds should be credited to this account. Earliest debit in the account would be adjusted first out of the credits made into the account, irrespective of the contract to which such debits and credits relate.

Documentation

All documents taken for advance against goods, viz., Demand Promissory Note, hypothecation or pledge agreement, etc., should be taken for packing credit also. In addition some banks have a separate packing credit agreement.

4.6 POST-SHIPMENT CREDIT:

The exchange control regulations stipulate that within 21 days of shipment of goods from India, the exporter should submit the relative documents for collection/purchase to an authorized dealer. The documents prepared would be as per requirements of the letter of credit, if one exists, or as per the sale contract between the exporter and the importer.

For those parties who have been granted a packing credit, the understanding is that the packing credit would be adjusted out of the bills tendered under the export contract. Therefore, alone with sanctioning of the packing credit limit, the party would have been sanctioned foreign bills purchase/negotiation limit also. For other, depending upon their requirements, only the bills purchase/negotiation limit might have been sanctioned. For such of the parties who only make occasional exports, regular limit for purchase may not have been sanctioned, but depending upon the worth of the party, bills tendered may be purchased on an ad hoc basis, thus bills drawn by the exporter may be:

Purchased/negotiated by the bank where it is drawn under a letter of credit;

Purchased/negotiated by the bank where is not drawn under a letter of credit; or taken for collection by the bank.

4.7 ADVANCE AGAINST DUTY DRAWBACK

The import duty paid on raw materials or components for export products or the excise duty paid on items indigenously produced for export are repaid to the exporter on completion of the export. The items on which duty drawback is available is determined by Government polices.

The need for advance against duty drawback arises cause of the delay involved in verifying the claims of the exporter by the authorities concerned and payment of the drawback by them. The exporter funds are locked up during this interval and be seeks financial assistance from the bank to tide over the situation.

Normally, the exporter can claim the drawback amount from the customs authorities only after export of goods by producing the necessary documents to them. But bank finance against incentives may be made available either at the pre-shipment stage or at the post-shipment stage.

Advance at the pre-shipment stage may take the form of packing credit being granted at a level higher than the FOB value of the contract. As already discussed under pre-shipment finance, bank can grant packing credit advances up to certain percentages above the FOB value, but not exceeding the domestic cost of production in respect of goods which are entitled for duty drawback from the government. In such cases, the excess over FOVB value advanced by the bank amounts advance against duty drawback. Advance against drawback at the pre-shipment stage is granted only to exporters of goods standing on their furnishing satisfactory evidence to the bank case to the amount of their entitlements when he makes claim with the concerned authorities.

Check Your Progress

5 Advance against incentives can be granted for a maximum period of_____days . ddays

4.8 FINANCING EXPORTS

Advance may also be made at the post-shipment stage as a separate limit. The advance will be disbursed when the exporter makes a claim with the concerned authorities and produces copies of the claims to the bank.

As per the Reserve Bank of India directive, advance against incentives can be granted for a maximum period of 90 days at an interest rate of 13% per annum. The advance is to be adjusted out of the incentives to be received by the bank on behalf of the exporter. All claims are now payable directly to the bank. A declaration by the export er authorizing to the bank should be registered with the concerned authorities

The bank may prescribe a margin after considering the merits of each case. If the sanction is made as a part of packing of credit, the documents taken for packing credit, the documents taken for packing credit would be sufficient for this facility also. If the facility is granted as a separate limit, an agreement for hypothecation of book debts may be taken. The advance can be covered under Export production finance guarantee or

export finance guarantee of ECGC. It is to be adjusted out of local funds, i.e., not the export incentive. Domestic rate of interest is charged from the date of advance.

4.9 OTHER SERVICES TO EXPORTERS

Advising Letters of Credit

The letter of Credit rupee and the PCFC is availed in Indian rupee, yet liability of the exporter under PCFC will be designated in foreign currency, say, US solar, in such case, the exporter may book forward cover as under:

From the date order/letter of credit to the date of drawl of PCFC covering the amount of PCFC sanctioned; and

From date of order/letter of credit to the date of discounting converting the invoice less PCFC sanctioned/drawn.

If the exporter avails PCFC in a currency other than the currency of invoice forward cover may be booked as follows:

Forward cover in the currency in which PCFC is availed of and the rupee from the date of order/letter of credit to the date of drawl of PCFC, converting the amount of PCFC sanctioned.

Cross currency forward cover in the currency in which PCFC is availed against invoiced currency from the date of order/letter of credit to the date of discounting.

Forward cover from the date of discounting between rupee and the currency in which PCFC is taken, to the extent of amount available after discounting of bills and repayment of outstanding of outstanding PCFC.

On availing of PCFC, the contract should be cancelled at prevailing market rates to the extent of PCFC drawl used for payment towards imported inputs in foreign currency.

NOTES

4.10 SUMMARY

Thus this chapter reveals the pre and post shipment credit and its procedures while using in international trade. Also, it clearly depicts the financing and other services of exporters.

4.11 KEY WORDS USED IN THE LESSON

Pre-shipment credit

Post-shipment credit

Financing exporters

4.12 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1 180 days

.2 1973

3 A pre-shipment credit of packing credit is any loan of advance granted to an exporter for financing the purchase, processing, manufacturing or pacing of goods for export.

4 Supplier

5 90 days

4.13 MODEL QUESTIONS

1. What do you understand by pre-shipment credit?

2 Bring out the eligibility conditions of packing credit in international trade.

3. What do you mean by Direct Exports?

Essay Questions

1. Describe the various measures adopted in Pre-shipment credit.

2. What are the procedures adopted the bank while appraising under packaging credit?

NOTES

4.14 FURTHER READING

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

NOTES

UNIT – V

THEORIES OF FOREIGN EXCHANGE

UNIT STRUCTURE

5.1 Introduction

5.2 Unit Objectives

5.3. Theories of foreign exchange rate

5.4 New Exchange arrangements

5.5. Basic concepts of foreign exchange

5.6. Foreign exchange transactions

5.7 Summary

5.8 Key words used in the lesson

5.9 Answers to check your progress questions

5.10 Model Questions

5.11 Further reading

5.1 INTRODUCTION

The short term rate of exchange is determined by the supply of and demands for foreign exchange in the foreign exchange in the foreign market, the long – term equilibrium foreign exchange rate is determined differently under different monetary systems.

5.2 UNIT OBJECTIVES

1. To understand the theories of foreign exchange
2. To know the balance of payment theory

3. To study the various exchange rate

4. To identify the concepts of foreign exchange rate

5.3 THEORIES OF FOREIGN EXCHANGE RATE

NOTES

When the two countries are on the gold standard, basis of their gold contents, i.e., on the basis of parity between the mint ratios of the currencies of the two countries. The theory explaining the determination of the foreign exchange rate under the gold standard is known as the Mint parity Theory of foreign exchange rate. When the monetary systems of the two countries are not on the gold standard and their currencies are inconvertible into gold, the exchange rate in such a situation connote be determined on the basis of mint parity of the money standard, the basis of exchange determination of the purchasing powers of the two countries money units. The theory explaining determination the equilibrium rate of the exchange under inconvertible currency is known as the Purchasing Power Parity Theory.

When the currencies of the two countries are dissimilar but convertible, i.e., when one country is on the gold standard and the other is on the silver standard the exchange rate between two such currencies will be determined in the same way as is determined under the gold standard as long as the market ratio between gold and silver remains stable, i.e., on the basis of mint par. But if the market ratio between the two metals changes, the mint par forming the basis of exchange rate between the two countries" money units will also change, it, therefore, follows that when there are dissimilar currencies - gold and silver – in the two countries, the equilibrium rat of foreign exchange is determined on the basis of mint par that varies with changes in the market ratio between the two metals in the countries concerned. The rate of exchange can neither remains for long above the moving par because silver will be the theory will be equally valid either under silver or under any other full-fledged metallic standard. Shipped from the gold standard country not it remains for long below the moving par because gold will be shipped out of the silver standard country. We may now discuss the different theories of determination of the foreign exchange rate in detail.

Check Your Progress

1 The Purchasing Power Parity theory explains the determination of the equilibrium rate of the exchange under _____.

5.3.1 Mint Parity Theory

The mint parity theory of determination of foreign exchange rate explains the determination of exchange rate between the currency units of the gold standard countries. When two countries are on the full-fledged gold standard, their currency units are either made of gold of given purity and weight or are freely convertible into gold of given purity at fixed rate. In short, the gold value of the money units is unambiguously determined. Under gold standard, the countries maintain the value of their currencies in a fixed relationship to the value of gold by committing themselves to by and sell gold at fixed prices. A nation is said to be fully on the gold standard if the government of that county (1) buys and sells gold in unlimited quantity at an officially fixed price, and (2) permits unrestricted gold glows into and out the country. The practical meaning of (1) and (2) is that an individual who holds domestic currency knows in advance how much gold be can obtain in exchange for it and how much foreign currency the exchange rate between the gold standard countries" currencies will fluctuate around the fixed mint par within the narrow range determined by the cost of exporting and importing gold known as the specie points. By mint par basis of the metallic contents of the two money units, allowances being given exchange rate is applicable only when the countries are on the weigh-to-weight to the purity of the metallic contents. The mint parity theory of foreign exchange rate is applicable only when the countries are on the same metallic standard which in practice has taken the from of either the gold or the silver standard. Thus, there can be on fixed mint par between gold and a silver standard country.

Check Your Progress

2 The mint parity theory of foreign exchange rate is applicable only when the countries are on the _____ metallic standard.

Before World War I and during the late 1920, England and America were simultaneously on the gold standard. The British sovereign equivalent to one pound contained 133.0016 grains while the US gold dollar contained 23.2200 gold contents ratio between the two currencies, the exchange rat between the 113.0016/23.2200, i.e., 4.866 showing that 4.886 US gold dollars were equal to one British gold sovereign or pound, i.e., Li = US $4.886.

The foreign exchange rate determined on the basis of the gold contents of the two currency units, i.e. on the basis of mint parity is a normal rate which would prevail in the

long-run. The market rate of exchange may and does differ from the long-run-mint parity equilibrium rate of exchange within the narrow limits fixed by the cost of shipping gold, including insurance, packing, and interest charges for the period spent in the transit of gold from one county to another. When the two countries, say the United States and England are on the gold standard an American importer desiring to covert US dollars into ways. He can either buy the pound sterling foreign exchange against the dollars in the foreign exchange market of he can export gold from America to England. If it did not entail any expense in exporting the gold from America to England an effective foreign exchange rate of US $4.886 – Li would be established in the free foreign exchange market.

The export of gold, however, involves expenses. Before it can be exported gold must be carefully packed. Beside the expenses involved in packing, freight and insurance cost have also to be incurred. Similarly, some interest income is lost while gold is in transit. There is also some small loss resulting from abrasion. Furthermore, the central bank in the gold receiving county may charge a fee for minting. Thus, there are a host of expenses which must be incurred by the American importer while marking payment to his British exporter through exporting gold. The American importer will, therefore, export gold only if the market rate of exchange is higher than the mint parity cost of exporting gold from America to England and Vice Versa is 2 cen ts per foreign payments if the exchange rate in the foreign exchange market was either lower than or equal to US $4.886 = Li. In other words, so long as the American importer can buy the sterling – exchange in the foreign exchange market either at or below the rate of US $4.886 = Li, he would not export gold in payment for his imports from England. Similarly, the British exporter will not import gold if he can sell his dollar drafts @ Li = $4.886 in the London foreign exchange market. Thus these are the upper and lower limits determined by the cost of exporting and importing gold between the gold fluctuate. These limits of fluctuation in the market foreign exchange rate are export point is obtained by adding the cost of exporting gold to the mint parity deducting the cost of importing gold from the mint parity rate of exchange. Thus, the market rate of exchange between the US dollar and the pound sterling may be anything between $4.886 to one pound-sterling when the cost of shipping gold worth one pound-sterling between America and England is 0.2

cents. The actual day - to day rate of foreign exchange within the upper and the lower gold points will be determined by the total demand for and the total supply of foreign exchange.

There would be not shipment of gold so long as the market rat of exchange stays within this range which is determined by the gold points. If the market rate of exchange exceeds the gold export point i.e., $4.886 = Li, it would be economical for the American importer to export gold to England than to buy the pound – sterling bank draft payable in London in the foreign exchange market because in exporting gold he does not have to incur more than 2 cents as transport costs which when added to the mint parity exchange rat of $4.886 = Li, this critical rate above which gold will be exported out of country is called the „gold export point" Conversely, the market rate of foreign exchange will not fall below more than two cents from the mint parity rate of exchange i.e., below $4.886 =

Li, because below this rate of exchange gold will be imported into the country by the exporter, this rate is known as the „gold import point". A market foreign exchange rate beyond these two gold point is impossible because so long as the more economical possibility of gold shipments existed, no American importer would pay more than $4.886 for a pound – sterling when buying the pound exporter would accept less than S4.886 for a pound – sterling when selling the dollar draft in the London foreign exchange market.

The gold points are important in the whole discussion of the determination of foreign exchange rate under the gold standard because they determine the maximum fluctuations to which the market rate of foreign exchange in the free foreign exchange market is subject from day – to – day. The gold points also tell us why the market rate of foreign exchange differs from the normal or equilibrium rate of foreign exchange determined on the basis of the mint parity. The determination of the gold export and the gold import points and the market rate of foreign exchange on the basis of the demand for and the supply to foreign exchange between these two points.

It is obvious that the day-to-day or the market rate of foreign exchange fluctuates in accordance with the shifts in the supply and demand curves of foreign exchange within the total rang of 4 (2 +2) cents determined by the gold export and gold import points.

The market rate of foreign exchange fluctuates within the limits determined by the cost of shipping gold represented by the upper and the gold lower specie points. Between the range set by the gold export and the gold import points the foreign exchange rate is determined by the demand and supply forces. The figure shows the situation under conditions of stabilizing speculation because the demand and supply forces. The figure shows the situation under conditions of stabilizing speculation because the demand curve for foreign exchange rate shows no pull toward the mint parity which serves no more than the basis for calculating the gold points. The actual or market rate of foreign exchange, the mint parity rate of foreign exchange although is could be anywhere within the range set by the gold export and gold import points.

Depending upon the position of the demand and supply curves, the gold export point, the normal demand curves are non-operative. It is because at these two points the supply of and the demand for foreign exchange becomes perfectly elastic. When the rate of foreign exchange reaches the gold export points of $4.886 = Li, it will not rise any further even when at this rate of exchange the demand for foreign exchange in the market is more than the supply of foreign exchange at that rate because any shortfall in the supply of foreign exchange in the foreign exchange market shall be met through gold exports. Conversely, the rate of exchange cannot fall below the gold import point of $4.886 = Li because at this rate of exchange gold shall be imported in the country. Thus, the market rate of exchange shall fluctuate within the range set by the gold import and the gold export points, i.e., within the range of 2 + 2 = 4cents only.

Under international gold standard system, exchanges in the foreign exchange rate between the gold points had great significance between distant money markets where the costs incurred on the shipping of gold separated the two gold points by a considerable margin. Some of these changes were regular and stabilizing speculation benefited considerably by these changes. For example, before World War I due to heavy imports in the spring, the American dollar used to remain weak becoming strong in the fall when it was in large demand due to wheat and cotton exports. Consequently the dollar used to move near the gold export point in the spring while it tended to hover near the gold import point in the fall. Speculators conducted safe transactions by buying dollars

against sterling in the spring with the object to sell them in the fall as result of the stabilizing exchange activities of the speculators, the movements in the foreign exchange rate were prevented from touching the extremes of the gold points.

When there is a wide change either in the demand for or in the supply of foreign exchange, the gold flows generated as a consequence of change in the foreign exchange rate will balance the demand for and supply in the short period. When the demand for pound-sterling exceeds the supply available at the foreign exchange rates (prices) between the gold points, the excess demand will be met through gold exports which convert dollars into pound-sterling. When the demand curve for pound - sterling shifts from DD to D1, the equilibrium at A is no more relevant. The new equilibrium tales place at D1 where are excess demand for foreign exchange SD1 is met through the gold exports, conversely, a right word shift in the supply curve for pound sterling from SS to S1 will push down the foreign exchange rate to the gold import point where the excess supply of pound sterling foreign exchange will be partially satisfied through the gold imports announcing t DS1 which represents the excess supply.

Price-Specie –Flow Mechanism

Not withstanding that under the international gold standard the market rate of foreign exchange could deviate from the mint parity rate of foreign exchange between the two gold standard countries money units, it tended to adjust itself to the latter, i.e., although in the short period the market rate of exchange may be either lower on higher than the mint parity rate of exchange, in the long-run it tends to be equal to it because when the market rate of foreign exchange deviates form the mint parity rate of foreign exchange, forces of foreign exchange, forces of equilibrium is restored. The market rate of foreign exchange can differ from the long-run equilibrium rat of foreign exchange either by falling below it or by rising above it. This will happen when a country"s in transitional balance of payments in out of equilibrium, i.e., when it has either deficit due to the excess of overall imports over overall exports or has surplus due to the total exports exceeding the total imports.

In such a situation, equilibrium in the international balance of payments of a country is restored through the automatic mechanism of gold inflows and outflows. The price specie flow mechanism was first expounded by Dravid Hume in the eighteenth century and was subsequently elaborated by other. At this time it was regarded as a revolutionary nations as it led to destroy the mercantilist view that an increase in exports leading to gold imports was desirable. Hume insisted that gold inflows would increase the country"s imports and decrease her exports. Adam Smith noted this fact which was later elaborated by Dravid Ricardo and John Stuart Mill. The market rate of exchange between the money units of two gold standard countries is anchored themselves to the mint parity exchange between the money units of two gold standard countries is anchored themselves to the mint parity exchange rate. When a country has deficit in her balance payments, the equilibrium in the balance payments, the equilibrium in the balance of payments of the country is brought about through a chain of causation and counter – causation. The excess of imports over exports, reflected in the adverse balance of trade that country and gold inflows into the country enjoying favourable balance of trade. The exodus of gold from the former country causes construction in the money supply leading to recession as consequence of which prices and incomes fall in the country. Since the fall in prices in the gold – losing country in general, prices of export goods also fall marking that country"s goods cheaper for the other country. Similarly, some of the goods which the nationals of the gold – losing country imported from the other country would no longer be imported because in the changed new situation these goods become costlier. Consequently, gold - losing country"s exports are stimulated and her imports are reduced. The opposite chain of events operated in the country with a favourable balance of trade which experiences god inflows in the gold-losing country the money supply expands. Following this, incomes and prices rise in the country. As result upwards to the price and income effect of goods in the county, the demand curves for all the goods shift upwards to the right. Consequently the imports expand while the exports contract due to the incomes and price effect of the gold inflows in the gold-receiving county. In other words, through the inflationary process in the gold-receiving county and deflationary process in the gold – losing country, equilibrium in the balance of payments equilibrium with fixed foreign exchange rates is possible at the heavy cost of sacrificing the domestic cost-price

stability in the two countries. This classical analysis is known as the price – specific – flow analysis. Thus, the automatic gold flows initiated under the gold standard between the two gold standard countries bring the market rate of exchange in line with the mint parity rate of exchange when it deviates from this norm.

The price – specie – flow mechanism under the international gold standard occupied a prominent place in the classical explanation of foreign exchange rate. Like most of the classical doctrines, the price – specie – flow mechanism stresses the importance of price changes in bringing about and maintaining the balance of payments equilibrium. The logical link between the balance of payments situation and the price levels with fixed exchange rates is provided by the quantity theory of money which was a central pillar of the edifice of classical economics. Since gold standard no longer exists, the scope for the application of the mint parity theory of foreign exchange rate does not exist today. Under the old gold standard, exchange rate stability was achieved at the heavy cost of causing instability in the domestic costs, prices and incomes. In other words, exchange rate stability was achieved by subjecting the economies of the gold standard countries periodically to either inflation or deflation. Furthermore, the much publicized gold – flow mechanism could at best correct only a mild disequilibrium in the balance of payments position. If the balance payments disequilibrium was may not restore equilibrium in the balance of payments of the concerned countries. While it is true that disequilibrium in the balance of payments reacts upon the foreign exchange rate through gold – flows and the consequent change in the gold – losing and gold – receiving countries exports (supply of foreign exchange) and imports (demand for foreign exchange), I is not, clear that the adjustment mechanism takes place in the neat manner described by the classical writers. It became evident in the nineteenth century that with the increasing use of short – term credit and fractional reserves, the working of the price-specie – flow credit and fractional reserves, the working of the price – price –specie – flow mechanism was far from being simple and clear cut. Firstly, commodities are not the only important constituents of the balance of payments of a country. Capital movements and services are also important in the total transactions entering in the external balance of payments of a county. Secondly, gold is not the first item to move. Short – term – funds, securities etc., move earlier than gold, Consequently, if equilibrium

in the balance of payments of the concerned countries is brought about trough capital flows, commodity prices may not be affected and the working of the prices – specie – flow mechanism may be thwarted, in the nineteenth century, central banks under pressure of heavy gold outflows prevented price specie flow mechanism from working of the prices – specie – flow mechanism may be thwarted, in the nineteenth century, central banks under pressure of heavy gold outflows prevented price specie flow mechanism from working by resorting to tight money policies in their rediscount operations. The tightening of credit by raising the discount rate caused discrepancies between the short – term rates in different countries stimulating short – term funds to flow into the country. The inflow of such funds was often sufficient to close the gap in the current balance of payments or even when gold flows in, it goes to the central bank where it may be locked up in central bank cellars and it may not lead to and increase in the money supply. It had actually happened in America when the Federal Reserve Authorities through the „Sterilization" of gold imports prevented the massive gold inflows in the thirties from expanding the money supply in the country.

Further one, the theory of the gold movement"s places unduly great reliance on the flexibility of the cost – price structures of the gold standard countries. It assumes that prices promptly fall in the gold – losing – county and rise in the gold – receiving country. This involves the required fall in the wages rise in the gold losing country to whatever level is necessary to restore equilibrium in the country"s balance of payments. For this to happen, an institutional arrangement – Laissez Faire – conductive to such changes must exist. England had returned to the gold standard in 1925 at the old parity with the pious hope that England"s economy was flexible and wagers would fall. But trade unions resisted wage cuts that were necessary to correct the heavy balance of payments deficit. Strikes paralyzed the British economy. In the present era of welfare state, with the minimum wage legislations and price support programmers, the theory of gold movements is an anachronism.

The theory of gold movements is also based upon the heroic assumption that the burden of correcting the balance of payments disequilibrium is shared approximately evenly by both the countries. This can happen only when the two countries involved are

of equal economic size and trade in the two commodities of almost equal unit value. Where trade takes place between a small county like England and a large country like America, prices may fall substantially in England when gold involves since the entire gold is exported out of country while there will be only a marginal rise in prices in the USA following the gold involves since the entire gold received in a very small part of the US massive monetary gold reserves.

The effectiveness of the classical price specie flow mechanism depends on the elasticity"s of the demand for imports. It assumes that the demand for imports in both the countries elastic so that when prices fall the gold losing country, the demand for her exports increases by more than the green proportionate fall in prices while the demand for imports in the country falls by more then proportionate rise in their prices in the gold – receiving country. Thus on both counts, the balance payments gap tends to close. If, however the demand elasticity"s of imports and exports are very low i.e., if the demand for imports and exports is inelastic, the balance of payments gap will not close as a consequence of the gold movements, rater it may yawn further.

Check Your Progress

3 The purchasing power parity theory of foreign exchange rate determination was started by _____.

5.3.2 Purchasing Power Parity Theory

The purchasing power parity theory of foreign exchange rate determination was started by John Wheatley in 1803 in his famous work remarks on Currency and commerce.

It was later developed by the Swedish economist Gustav Cassel after the breakdown of the gold standard on the outbreak of World War 1. According theory, the normal equilibrium rate of exchange between two inconvertible currencies is determined by the radio of their purchasing powers of the two currencies. For example, a given amount of certain goods and services demanded in the two countries, say in America and England, can be purchased for $800 in America and for L200 in England pounds. In other words, US $800 = L200 or $4 = Li. If the rate of foreign exchange deviates from this norm, forces of equilibrium will come into operation and will bring back the long run exchange deviates from this norm. The prices in the two countries remaining unchanged, if the long run move to Li - $4.5, it shows that the purchasing power of pound sterling in

terms of the dollar has rise. People owning pound sterling will convert them into dollar at this rate of exchange, purchase goods in America for 4 dollars which in England cost one pound sterling and earn profit of + dollar. This tendency on the part of British people to covert their pound sterling into dollars will 4 according to John Maynard Keynes, the term purchasing power parity was first introduced into economic literature by Gustav Cassel in an article published in the Economic Journal in 1918. For Cassel"s views on the theory see is book money and foreign exchange after 1914, which was published in 1922.

In his book entitled „The Theory of International Prices", Angell has shown that this theory which is usually associated with, Gustav Cassel is much older? In the famous Bullion Report in 1810 the theory was stated thus: In the event of the prices of commodities being raised in one country by an augmentation of its circulating medium while no similar augmentation in the circulating medium of the neighboring country has led to a similar rise in prices; the two currencies will no longer continue to bear the same relative value to teach other as before. The exchange will be computed between two countries to the disadvantage of the former increase the demand for dollars in England while the supply of dollars in England will decrease because British exports to America will fall. As a consequence, pound – sterling price of the dollar will increase till it reaches the purchasing power parity rate of exchange of Li = US $4. conversely if prices in England rose by 100 per cent, those in America remaining unaltered, the dollar – value of the pound sterling will be halved. Consequently, on pound sterling would be equal to two US dollars because in the new situation two units of English currency purchase the same amount of goods and services in England as was bought by one unit before. On the other hand, in prices doubled in both the countries the purchasing power parity rate of exchange would remain unchanged. Gustav Cassel stated the theory in the context of paper money with special reference to the effects of currency inflation on foreign exchange rates. The following quotation represents early formulation of the theory by Gustav Cassel.

"Given a normal freedom of trade between two countries, A and B, a rate of exchange will establish itself between them and this rate will, smaller fluctuations apart,

remain unaltered as no alteration in the purchasing power of either currency is made and no special hindrances are imposed upon the trade, but as soon as an inflation takes place in the money of A and the purchasing power of this money is, therefore, diminished, the value of the A, money in B must necessarily be reduced in the same proportion. Consequently, the following rate: When two currencies have been inflated, the quotient between the degrees of inflation of both countries, there will, of course always be fluctuations from this new normal rate, and in a period of transition these fluctuation are apt to be currencies. This parity may be called the purchasing power parity, as it is determined by the quotients of the purchasing powers of the different currencies.

The purchasing power parity theory of foreign exchange rate applies to those countries which have inconvertible paper currencies. For countries on the gold standard, the mint parity suffices to determine the equilibrium rate of foreign exchange between two such countries currencies. The difference between the mint parity and the purchasing power parity is that while the former is fixed parity is that while the former is a fixed parity and the purchasing power parity is that while the former is fixed parity the purchasing parity is a moving parity which moves with the variations in prices in the countries concerned. Changes in the market rate of exchange arising on account of changes in the demand for and the supply of a particular country"s currency around this parity go on as before. The limits to those changes are determined by the cost of transporting goods.

Gustav Cassel, "Memorandum on the World"s Monetary Problems" International Financial Conference, Brussels, 1920, Document of the Conference, pp. 44-45. Inclosing tariff, insurance banking and interest changes, cost of uninsurable risks, advertisement of goods in the foreign market etc., from one country to another. These limits are not fixed unlike the specie points in the case of the gold standard countries. The upper and the lower limits to fluctuations of this moving parity are determined by the commodity export and import points. The market rate of exchange is determined by the intersection of the demand and supply curves of foreign exchange. With the gives S1S1 supply curve and D1D1 demand curve the rate of foreign exchange is OR1 which lies within the range of the commodity import and commodity export points. When the demand and supply

curve, change their position, as shown by D2D2 demand and S2S2 supply curves, the rate exchange rises from Or1 to OR2.

Criticism

According to the theory, there is a direct relationship between the purchasing power of the currency units and the rate of exchange. In practice, however, this is not always so. Foreign exchange rates are frequently influenced by factors other than the purchasing powers of the currencies in the countries concerned. For example, exchange rate can be influenced by tariff. If a country imposes tariff on her imports while other countries do not very retaliatory tariff, the exchange value of the currency of the tariff-levying country will rise although there is no change in no the domestic prices in the country.

The theory compares the general price level in the two countries without distinguishing between the prices of domestic goods and the prices of international goods. The prices of international goods are the same in the different countries when costs of transport, import duties etc., are taken into account. When it is said that the foreign exchange rate depends on the relative prices in the two countries. The price level should include the prices of all commodities many of which do not enter the areana of international trade.

Heacksher and others have criticized the theory on the ground that the purchasing power parity will be valid only if the analysis is confined to the prices of only those goods that enter into the international trade and if the relative changes in transport costs and tariffs are ignored. The theory is not valid when applied to the general price levels. Criticizing the theory Heckscher states: "The conception that the exchanges represent price levels or what is the same thing, that the monetary unit of a country has the same purchasing power both within the country and outside is correct only upon the never existing assumption that all goods and services can be transferred from one country to another without cost. In this case, the agreement between the prices of different countries is even greater than that which is covered by the conception of an identical purchasing power of the monetary unit, for not only average price level but also the price of each

NOTES

particular commodity or service will then be the same in both countries if computed on the basis of the exchanges".

The problem is that by considering the purchasing power as consisting only of the prices of internationally – trade goods, the theory is reduced to a mere tautology. On removing this restriction although the concept of purchasing power becomes meaningful, no reliance can be placed on it as a determinant of the rate of foreign exchange. In short, the theory does not furnish us with any simple measure of the "true" value of the foreign exchange rate.

Changes in prices can be measured by means of different index numbers. Taking the index numbers of wholesale prices and calculating the currencies purchasing power parities on their basis would ignore many manufactured goods and services and other invisible exports. On the other hand, if the cost of living index numbers are used for calculating the currencies purchasing power, many goods not entering into international trade will be included in the computation of purchasing power of the money units. If we take the wage indices, the position will be more satisfactory because wages figure in all goods cost of production. But here also the difficulty is that labor efficiency differs from country to country. In the short period, prices of all domestic goods do not change in the same direction. The theory therefore, holds good (6Eli F. Hechscher et al., Sweden, Norway, Denmark and Iceland in the world War 1930, 151). Only in the long period. But for all problems of life it is the short period but the long period which is important because in the long run we are all dead and after death there is no problem.

Moreover, many goods and services which are bought and sold in one country do not compete with their counterparts in the other country. For example, the demand for dry cleaning of woolens and hair cuts in India does not compete with the demand for dry cleaning of woolens and hair cuts in England. Moreover, due to shipping costs and import restrictions, the prices of even international commodities such as wheat, coffee, and rubber need not be same in different countries in terms of the domestic currencies. A price comparison of this kind reveals that internationally traded goods do not sell at the

same prices in the export and import markets. These goods sell at a premium in the importing country.

According to the theory, changes in prices must be reflected in changes in the foreign exchange rate. But we may have changing prices in the country co – existing with a fixed foreign exchange rate because "only internationally traded goods will influence the demand for and the supply of foreign currency and consequently, the rate of exchange Commodities which are only domestically traded, on the other hand, have not direct bearing on the exchange value of the currency and their prices may, therefore, fluctuate without affecting directly and immediately the exchange rate. Confined to internationally traded commodities, the purchasing power parity theory becomes an empty truism.

Check Your Progress

4 According to purchasing power parity theory, changes in prices may be reflected in _____.

The theory assumes that changes in prices induce changes in the foreign exchange rates, but changes in the foreign exchange rates exercise no influence on the prices. According to the theory the chain of causation is one sided. But the assertion that changes in foreign exchange rates do not influence prices is not always true. For example, if the massive speculative outflows of capital from England reduce the exchange value of the pound sterling and it if it remains depressed for several months, imports in England will become costlier. Consequently, more money will be needed to pay for the imports of American wheat and other goods. Many British industries use imported raw materials. Since prices of imported raw materials have risen, the prices will become cheaper in terms of the US dollar and the demand for them will increase. Consequently. British exporters may successfully raise prices of export goods, particularly in the short period when their supply is inelastic. If they raise the prices of export goods by less than the amount of depreciation of the pound – sterling, the exporters will increase their profits without reducing their total exports. But in sprite of the prices of exports having raised these are cheaper in America. Thus, prices in England rise as a result of the fall in the dollar value of the pound sterling. But this is not all. The pound sterling having depreciated, the competitive strength of the British export industries in foreign markets. Thus, other countries will also reduce their export prices in order to retain their hold on the foreign markets in the face of growing competition from

British Exports. In short, depreciation of the pound sterling not only raises prices in England but also causes pierces to be lowered in other countries. The sequence of events traced here is the opposite of that predicted by the theory. The experience of some countries leads to the conclusion that foreign exchange rate governs prices rather than the latter governing the former. According to Halm, domestic prices follow rather than precede the movement of exchange rates. He states: "A process of equalization through arbitrage takes place so automatically that the national prices of commodities seem to follow rather than to determine the movement of the exchange rates".

Changes in the foreign exchange rate affect the prices differently in different countries. If a country imports consumer goods in bulk and devotes its economic resources mostly to produce export goods the effect will be large. Changes in the foreign exchange rate will affect both the prices of imports and exports, and when imports and exports from a large part of total in the foreign exchange rate will be larger. Thus, a given change in the foreign exchange rate will effect prices a good deal more in small countries like Holland, Belgium and England where foreign trade is a dominate sector of the national economy than in all larger country like USSR of USA where foreign trade is a small part of national economy. Thus, although changes in the foreign exchange rate may exercise different countries, they always exercise some effect. It is, therefore, wrong to say that changes in prices cause changes in the foreign exchange rate and that changes in the foreign exchange rate do no cause changes in prices.

The theory ignores the demand for and the supply of foreign exchange arising from sources other than international trade in visible goods, i.e., it considers only the imports and exports as factors of demand and supply of foreign exchange also arises on account of the imports and exports of invisible services like insurance, shipping, banking etc., from flow of short-term funds and from other unilateral transfers involving reparation payments, making of gifts, payment of loans and interest by one nation to another. Long-term investment, transfer of capital movements also create dividend payments and short-term speculative capital movements also create debits and credits in the international balance of payments of a nation influencing the foreign exchange rate. The foreign exchange rate is the result of the working of a vast complex of forces

summarized b the balance of payments, and not mere by the balance of trade. In short, the purchasing power parity theory is incomplete. It does not offer a complete explanation of the determination of the equilibrium rate of foreign exchange between inconvertible currencies.

The theory does not consider the fact that economic relation between countries might change following which the equilibrium rate of foreign exchange may also change, although prices in the concerned countries may not change at all. For example, when some third country makes entry in international trade as a competitor, either as a purchaser or as a seller of goods, the flow of trade between the two original countries will be effected, effected, affecting also the foreign rate between their currencies. Ranger Nurkse has criticized the theory on the ground that it considers only; the price movements as the main criterion and ignores the other important factors influencing the demand for foreign exchange. According to him, the theory "treats demand simply as a function of price, leaving out of account the wide shifts in the aggregate income and expenditure which occur in the business cycle (as a result of market forces or government polices), and which lead to wide fluctuations in the volume and hence the value of foreign trade even if prices or price relationship remain the same".

Conclusion

Notwithstanding the criticisms, the purchasing power parity theory is not useless as an explanation of the forces determining the foreign exchange rate and it should not be discarded. Despite its deficiencies, the theory has a practical significance from the point of view monetary policy. It warns countries that there are certain things which they cannot do. In May 1924, England fixed the gold value of the pound-sterling higher than was justified by the prices in prevailing at that time in the country. According to the theory, the high exchange value of the pound-sterling could be maintained only if prices in England were lower relatively to world prices. Failing that fact the foreign exchange rate of the pound-sterling would have to fall. Government, however, tried to maintain the value of the pound – sterling by raising the discount rate and attracting foreign capital. A rise in the discount rate causes a fall in prices, wages and employment in the economy.

But wages could not fall in England due to the strike threat by strong trade unions and consequently prices remained high. The disequilibrium between the domestic price level and the foreign exchange rate persisted. When costs and price did not fall, as way required it was inevitable that the gold value of the pound – sterling must fall. This happened in September 1931 when England went off the gold standard causing great confusion in the world. In a period of fluctuating foreign exchange rates, the theory provides a rough measures of the degree by which the markets rate from the equilibrium rate of foreign exchange. When the calculation of foreign exchange rate stabilization is undertaken, the purchasing power parity provides a most important factor for the determination of proper foreign exchange rate which should be adopted. This especially true when price inflation has been a dominant cause of exchange rate instability. Although such calculations are crude indicators, yet they provide a method to arrive at specific conclusion as to the general location of the appropriate foreign exchange value of the purchasing powers of money in e.g.) England and the United States or Germany between 1813 and, say 1923, but it does not necessarily settle what the equilibrium exchange rate in 1923 between sterling and dollar or mark ought to be".

5.3.3 Balance of Payment Theory

The balance of payments theory which holds that exchange rate is determined by autonomous factors which are unrelated to domestic prices and the money supply was expounded during the First World War when the gold standard was suspended by one country after another. Under the gold standard, relative price changes induced by the specie – flows were necessary to restore equilibrium in the balance of payments. These price changes during war were produced by variations in the rate of exchange – depreciation. The problem was to find the general principle which determined the extent of depreciation. The problem was to find the general principle which determined the extent of depreciation. The balance of payments theory sought to provide an answer to this problem.

According to the theory, a passive (deficit) balance of payments leads to the fall or depreciation of the rate of exchange while an active (surplus) balance of payments, by

strengthening the foreign exchange, causes an appreciation of the rate of foreign exchange. An adverse international balance of payments of a country of a country shows a situation in which the demand for foreign exchange (currency) exceeds its supply at the given rate of exchange. Consequently, its price in terms of the domestic currency must depreciate. Conversely, if the international balance of payments of a country is favourable it means that there is greater demand for the domestic currency in the foreign exchange market than can be met by the available supply at any given rate of foreign exchange. Consequently the price of a unit of home currency in terms of foreign currency, i.e., the rate of exchange moves in the favour of the home country and unit of home currency begins to command more units of the foreign currency.

In its native from the theory aspects that exchange rates are determined by the state of the international balance of payments of countries in the sense of supply and demand like the determination of any other price. While it cannot be denied that the rate of exchange is a function of the supply of and the demand for foreign exchange the questions is. What determines the supply of and the demand for foreign exchange? The balance of payments theory in its sophisticated form answers the question by asserting that the balance of payments position (and, therefore, the supply of and demand for foreign exchange) is determined mainly by factors that are independent of changes in the rate of exchange. Some of these independent factors that affect the exchange rate consist of autonomous payments – payments that are not affected by changes in the rate exchange – which consist of the reparation payment and payments of interest on foreign loans etc. Beside these autonomous payments, the demand for certain imports, particularly for essential raw materials, may be inelastic and, therefore, insensitive to changes in the foreign exchange rate.

The theory has certain strong points as an explanation of the determination of exchange rate. Firstly it is compatible with the general of value to state that like the price of a commodity the rate of exchange should also be determined=ed by the supply of and the demand for foreign exchange. Secondly it brings the determination of the exchange rate within the purview of the general equilibrium theory. Thirdly, the theory emphasis that there are many significant forces, beside those of exports and imports of goods,

which are influenced by prices included in the balance of payments which by influencing the supply of and the demand for foreign exchange affect the rate of payments of a country can be corrected by making appropriate adjustment in the foreign exchange rate, i.e., either by devaluing or by revaluing the currency unit of the concerned country. It is significant because under the mint parity theory of foreign exchange disequilibrium in the balance of payments could be corrected only through inflation or deflation causing the price instability in the county of a country.

The main defect of the theory is that it assumes the balance of payments to be a fixed quantity. In the Keynesian metaphor, it applies the theory of solids where the theory of liquids would be more appropriate. The state of the balance of trade depends upon the relationship between the domestic and foreign prices. What the prices expressed in the foreign currency are in the foreign country depends apart from domestic prices, also upon the rate of exchange between the two currency units. A rise in the rate of exchange is equivalent to a rise in prices abroad in relation to prices at home while a fall in the foreign exchange rate indicates a fall in prices abroad assuming no change in prices in the home country.

The second criticisms of the theory is that is treats the demand for many imported raw materials as perfectly price inelastic and consequently independent of changes in the prices and foreign exchange rate. However, perfectly inelastic demand for a good is a very rare phenomenon. Even the most essential commodity has some price elasticity of demand. Let alone the demand for essential raw materials, even the demand for imported good grains (food is most essential for life and hence its demand is inelastic) has some elasticity because the same physiological needs can be satisfied either by consuming cheap commodities like ordinary breads and vegetables or by expensive ones like meat and fruits. In other words, even in the case of essential to life goods, some substitution is possible, consequently, the demand for even these commodities shows some response to variation is their prices which are affected by changes in the foreign exchange rate. The balance of payments is not; therefore, completely independent of the foreign exchange rate, it is parity dependent upon the rate of exchange and changes it. Thus, the balance of payments, being itself a function of the rate of exchange, cannot explain the rate of

exchange. This criticism was made by economist of the Inflation School who argued that the German currency mark would never have depreciated to the extent it did if the supply of money had not been continuously increased. It was due to only persistently rising prices at home that obstructed the expansion of German exports and the construction of German imports.

5.3.4 Stable foreign Exchange Rate

There has been a good deal of controversy about the superiority of stable foreign exchange rates over their flexible foreign exchange rates. Supporters of both have advanced their arguments in defense of the particular exchange rate system. The following arguments have been advanced in favour of the stable foreign exchange rates as against the unstable foreign exchange rates.

Stable exchange rate facilitate the development of international trade by enabling the importers and exporters to know in advance how much they will have to pay and how much they will receive in terms of the domestic currencies. On the other hand, freely fluctuating exchange rates add to the hazards of international trade by making the calculation of prices in terms of domestic currency uncertain and difficult.

In an era of extensive overseas investment and economic development, the progress development plans in the underdeveloped countries may be jeopardizeb by unstable exchange rates because the flow of foreign loan and equity capital vital for economic growth is retarded by the speculation about currently appreciation or depreciation. Foreign lending is promoted by a system of stable exchange rates because the lender knows what he will receive in his own currency if the debt is fixed in borrowers" currency and the borrower knows what he will have to pay in his currency if the debt is fixed in terms of the lender"s currency.

Stable exchange rates are suited to the development of regional arrangements such as the sterling area or dollar area where a fluctuating foreign exchange rate for the reserve currency can become a bone of contention between the members of the area.

For small notions like Demark, Belgium and England in whose gross national product foreign trade sector contributes significantly, exchange rate stability is the only right policy for the government to pursue and less the country deviates from this policy the better for her. If the country does not stabilize the foreign exchange rate of her money unit, her foreign trade will be dislocated by fluctuations in the foreign exchange rate jeopardizing her economic prosperity. Thus, those small countries in whose national product foreign trade plays a significant role can ill afford the costly experiment of fluctuating foreign exchange rates, Moreover if they depend upon foreign capital for their economic development they must maintain the exchange rate stability at any cost so long as there are important countries abroad with a fairly stable monetary system to which they can peg their money unit are important countries abroad with a fairly stable monetary system to which they can peg their money unit.

Stable exchange rates are essential for orderly growth of international money and capital markets which are vital for international capital flows. The experience of the thirties shows that when the exchange rate fluctuate widely the foreign investors become chary of making long – term tending to foreign notional. So long as there existed a system of stable (pegged) foreign exchange rates under the pre 1914 gold standard, smooth flow of international long term lending continues after the breakdown of the gold standard an era of competitive exchange depreciation began disrupting international lending.

5.3.5 Flexible Foreign Exchange Rate

The flexible foreign exchange rates are supported by countering arguments advocated for stable exchange rates. It is claimed that stable exchange rates encourage the development of multilateral trading system. This argument is not, however, strengthened by the experience of the postwar years. Even not, however, strengthened by the experience of the postwar years. Even when the foreign exchange rate fluctuates from day to day, the trend of the currency units value in the foreign exchange market can be usually assessed, when the balance of payments of the country is in equilibrium, the foreign exchange rate will no alter significantly in such period because the average, trade

transaction takes time to complete, while in disequilibrium the trend trade transaction takes time to complete.

The problem of speculative capital movements under fluctuating foreign exchange rates in turn creates the more difficult problem of an unusually high liquidity preference. The gains and losses which can be made from unexpected depreciation of one currency anticipation is apt to bring its own realization. Anticipatory purchases of foreign exchange produce or at any rate hasten the anticipated fall in exchange rate of the national currency. The problem of speculative capital movements under fluctuating foreign exchange rates in turn creates the more difficult problem of an unusually high liquidity preference. The gains and losses which can be made from unexpected depreciation of one currency etc., while in disequilibrium the trend of the market may be judged. In either case, the forward foreign exchange markets provide protection to importers and exporters.

Secondly, the supporters of flexible foreign exchange rates argue that this system allows exchange rates can adjust the external balances and prevent the recurring balance of payments crises more effectively compared with the stable exchanges rates. Consequently, their effect on international lending is beneficial.

Fourthly, stable exchange rates are not necessary for any system of currency area. The sterling area is typical of a regional payments group whose framework was cast in the thirties when the exchange rate against the pound sterling was free to fluctuate in the free foreign exchange markets, certain economic, political and social ties had brought together the difference countries to form the sterling block and these would not be weakened if the pound sterling had a flexible exchange rate after making consultations with the members of the area.

Under flexible exchange rate system, the balance of payments adjustment is brought about through changes in exchanges rates rather than through change in domestic incomes and prices. To ease the problem of maintaining the external equilibrium without burdensome constraints on domestic economic policies, a county should allow its

NOTES

exchange rate to respond freely to the demand for and the supply of foreign exchange. Flexible exchange rate allow the country freedom in the monetary management.

Thus, some of the strong arguments against fluctuating foreign exchange rates have lost their force. Furthermore, stable exchanges rates suffer from certain other defects. A stable exchange rate encourages destabilizing currency speculation which, despite foreign exchange control, can endanger the stability of a currency and make it impossible for an exchange rate, once the currency falls under the suspicion of an impending devaluation to be maintained for a long period. Speculation regarding devaluation of the pound sterling played a vital role in bringing about that currency"s devaluation in September 1949, or of the Indian rupee in June 1966, or of the once impregnable US dollar in December 1971 and again in February 1973.

Furthermore, stable exchange rates do not reflect the existing and true cost price relationship between two currencies; they represent the rates which existed formerly. When countries follow different economic policies the cost exchange rates and the experience of the past few decades point to the desirability of abandoning the stable exchange rate system in favors of the flexible exchange rate system.

It must be remembered that except for brief interval of time, no country can afford to allow its foreign exchange rate to draft and follow the day to day developments in international and external economic conditions for any length of time. The instability resulting from such a policy will have serious repercussions not only on the foreign trade but also on the entire economy of the country. Fluctuating exchange rates are incompatible with the stability of the domestic economy. Uncontrolled fluctuations in exchange rates cause the prices of exports and imports to fluctuate. Consequently, certain goods which were not formerly internationally traded enter the arena of international trade while some other that were formerly so traded are excluded from international trade. As a consequence, not only the smooth flow and development of international trade but also the inter industry allocation of factors of production in the economy is disrupted. Fluctuating foreign exchange rates cause constant shift of domestic factors of

NOTES

production between export and home market industries; shift which may be disturbing and wasteful.

Moreover, fluctuating foreign exchange rates induce unwarranted capital movements; Speculation in foreign exchange becomes an attractive pastime. The massive capital outflows that take place in anticipation of currency devaluation are dangerous because such anticipation is apt to bring its own realization. Anticipatory purchase of foreign exchange produce or at any rate hasten the anticipated all in the exchange rate of the national currency or another have come to be realized more and more widely. People; therefore try to invest their money in an liquid a form as possible, in order to be able convert it at the first sight of danger into some other currency which appears at the moment to.

The problem of speculative capital movements under fluctuating foreign exchange rates in turn creates the more difficult problem of a unusually high liquidity preference. The gains and losses which can be made from unexpected depreciation of one currency or another have come to be realized more and more widely. People, therefore try to invest their money in an liquid a form as possible, in order to be able to convert it at the first sight of danger into some other currency which appears at the moment of offer greater security. This phenomenon of very high liquidity preference encourages hoarding and causes the rate of interest to rise leading eventually to decline in investment, employment and income in the economy.

Rangnar Nurkese, conditions of International Monetary Equilibrium, Essays in International Finance, No. 4, Princeton University Press, spring 1946, p.3

Gottfried Von Harbeler, Theory of International Trade 1950, p.3

The argument that it is necessary to allow the exchange rate to fluctuate to enable it to find its natural level does not have much force in it. There is no such thing as the natural level for the rate of exchange of a currency. The proper rate, in each case, depends upon the economic, financial and monetary policies pursued by the country concerned and by other countries with which she has important economic relations.

Moreover, whether or not a given exchange rate is at the correct level can be determined only after there has been time to observe the course of the international the pound sterling played a vital role in bringing about that currency"s devaluation in September 1971, or of the Indian rupee in June 1966, or of the once impregnable US dollar in December 1971 and again in February 1973.

It must be remembered that except for brief interval of time, no country can afford to allow its foreign exchange rate to draft and offer greater security. This phenomenon of very high liquidity preference encourages hoarding and causes the rate of interest to rise leading eventually to decline in investment, employment and income in the economy.

In a period of continuing inflation, freely fluctuating exchange rates cause a vicious circle of devaluation and inflation to emerge in the economy. As long as internal prices are not stabilized, fluctuating exchange rates are essential to prevent overvaluation of the currency. Yet under conditions of domestic price instability, the rate of exchange depreciates regularly contributing to greater inflation. The process cumulative inflation under a system of freely fluctuating exchange rates proceeds thus: A country"s balance of payments is in difficulties; the exchange rate depreciates; this raises the price of consequence; the maintenance of full employment then involves a domestic financial policy which causes the general levels of money incomes and prices to rise pair pass with the rise in wage rate; it further stains the country"s balance of payment already in difficulty necessitating further depreciation of exchange rate causing another round of the inflationary process to start. Furthermore, if a country does not promptly adopt a monetary policy aiming at economic stability, the movements of her fluctuating exchange rate are likely to be oscillations not around a stable value but around a declining trend.

Uncontrolled fluctuations in exchange rate are harmful because such fluctuations seriously hamper the flow of long term foreign investment, where foreign loans are contracted in terms of borrowing country"s currency, the creditor faces the hazard resulting from exchange rate fluctuations causing depreciation of the borrower s currency in relation to lender s currency. Even when the loans are contracted in lending country"s

currency, fluctuating exchange rate increases the hazard for the debtor country in so far as the depreciation of her currency increases the burden of her external debt servicing.

To conclude, some degree of exchange rate stability is essential for the smooth working of world"s economy. Perhaps follow the day to day developments in international and external economic conditions for any length of time. The instability resulting from such a policy will have serious repercussions not only on the foreign trade but also on the entire economy of the country. Fluctuating exchange rates are incompatible with the stability of the domestic economy. Uncontrolled fluctuations in exchange rates cause the prices of exports and imports to fluctuate, consequently, certain goods which were not formerly internationally traded enter the arena of international trade while some others that were formerly so traded are excluded from international trade. As a consequence, not factor of production in the economy is disrupted. Fluctuating foreign exchange rates cause constant shifts of domestic factors of production between export and home market industries; shifts which may be disturbing and wasteful.

5.3.6 Fluctuating Foreign Exchange Rates and IMF

Although the IMF was created four decades ago in 1945 to promote the exchange rate stability without subjecting the members to the rigid discipline of the gold standard in the matter of national monetary management, freely fluctuating exchange rates are not uncommon. The fund has been often criticized for its approach to the fluctuating foreign exchange rates or floating exchange rates.

Although the Fund has consistently supported the system of institutionally agreed par value of members currencies as required by its Articles of Agreement, pragmatic consideration have, however, induced the Fund to allow certain members in exceptional circumstances to practice fluctuating exchange rate system. Such a situation was first forced upon the Fund in July 1948 when Mexico suspended transactions at the par value of her currency and allowed the market to set the exchange rate for her currency. The Fund and the Mexican government held continuous consultations with the object of establishing a new par value for the Mexican peso. One year after the suspension of the

initial parity, a new par value was fixed, consequently for one full year the Mexican peso had a floating rate.

In November 1949, Fund"s attitude changed toward the problem of fluctuating exchange rates when Peru suspended transactions at the initial par value for the Peruvian sol which was currency and there were a dual exchange rate market with fluctuating exchange rate. Meanwhile during the two decoded Peru had maintained a system of floating rates and the Fund had allowed Peru to draw upon its resources and to assume the obligations of exchange restrictions and which had a convertible currency. The fund tolerated this action was the establishment of an appropriate unitary exchange rate system.

The second example of Funds acceptance of floating exchange rate in exceptional circumstance is that of Canada. The Canadian dollar floated in the foreign exchange market for about 12 years from September 1950 to May 1962. The fluctuating exchange rate was introduced to dampen a heavy inflow of the US capital funds which had become indeed massive 1950 adding to the money supply depressing the interest rates and augmenting inflationary pressures in the economy. The object of this floating rate was, therefore, in marked contrast to most other exchange rate changes which were intended to correct an adverse balance of trade and to check capital outflows. Due to the speculative nature of bulk of the inflowing capital, the Canadian Government was unable to foresee the end of capital inflows as long as the exchange rate was fixed. Consequently, to discourage the speculative capital movements that were inflationary in nature for the economy of the country, the Canadian Government left the Canadian dollar free in the foreign exchange market where exchange rate is was determined by the market forces of the supply of and the demand for the Canadian dollar. Recognizing the gravity of the situation, the Fund allowed Canada to let the exchange rate of the Canadian dollar remain floating in the foreign exchange market.

The other fund members which have had floating exchange rates for relatively long periods include Lebanon, the Syrian Arab Republic and Thailand in 1954. to facilitate Fund transactions in the currencies with fluctuating exchange rates such as fund

drawings in these currencies or payment of additional local currency in order to preserve the value of Fund assets – the fund set up special rules for computing the exchange rates of those currencies with fluctuating exchange rates. Computations were based on the midpoint between the highest and lowest rate for the US dollar quoted for cable transfer for spot delivery in the main financial center of the country of the fluctuating currency of specified days. Computations under this decision have been made only for those countries for which transactions no longer take place at their par value.

In a second circumstances, the Fund has gone some what further, in conjunction with exchange reform and stabilization, the Fund has supported programmers, which have include a fluctuating exchange rate. To some extent, Peru s fluctuating exchange rate had been introduced as part of an exchange reform. In some countries where a flexible exchange rate policy is deemed essential because of continuing inflation, a test has been set up as a means of assuring that a rate will be maintained which conforms to the basis market trends. Such a test consists of a prescribed minimum level at which the foreign exchange reserves of the country are to be maintained during a stated period with exchange rate action taken whenever there develops a threat to that level. Even so, since most countries have been reluctant to excessive depreciation of the exchange value of their currencies, the Fund had to tell the countries with flexible exchange rates not to stabilize the exchange rate of their currency units in hurry prematurely.

The ultimate objective of the Fund even in cases of exchange reform has been to create the conditions for the restoration of a stable and unified foreign exchange rate. The fluctuating exchange rate has been regarded as a temporary means to an end. The Fund has regarded a general system of fixed exchange rates and institutionally agreed par values as superior to a system of fluctuating exchange rates piously hoping that a few exceptions would not cause a return to the exchange rate instability of the pre Fund era. The fund has recognized the possibility that there may develop certain unusual circumstances forcing the country to adopt fluctuating exchange rate.

5.3.7 Adjustable Peg and Crawling Peg Foreign Exchange Rate Systems

In recent years, the debate between the supporters of fixed and fluctuating foreign exchange rate system has become increasingly intense. As a consequence of this renewed controversy, various new proposals aiming at achieving greater degree of foreign exchange rate flexibility while still retaining the important aspect of the Bretton Woods adjustable peg system have been advanced. One such proposal advanced as an alternative to the adjustable peg foreign exchange rate envisaged under the IMF scheme is the system of the crawling peg foreign exchange rate. The crawling peg exchange rate system, espoused in the mid sixties by economists of the eminence of William Fellner, John H. Williams, J. Black, James E, Meade and Carter J. Murphy, is largely based on the argument that the adjustable peg exchange rate system in the IMF scheme under which the Exchange rates could diverge exchange parity by not allowing a wide enough band for the exchange rate to more encouraged disequilibrating speculation about the ability of a member to maintain the exchange value of its currency at 1 per cent above or below the exchange parity.

It was argued that a major determinant of the effectiveness of any exchange rate system is the effect it has on the speculative movements of international money. Speculative capital flows are stimulated if and when the financial community feels that an exchange rate is likely to be changed and it can make profit by shifting funds from weak currencies to strong currencies. Greater the scope for the exchange rate to fluctuate smaller is the reason for the speculators to entertain fears about any impending devaluation of the currency. In fact, a freely fluctuating exchange rate is on the other extreme of the rigid exchange rate stability which exchange rates could diverge from their par values had been widened from 1 per cent to 1.25 per cent on either side of the exchange parity. This in effect means that in place of the old system of adjustable peg, new scheme, the exchange parity. This in effect means that in place of the old system of old system of adjustable peg, new scheme, the exchange rate could crawl within the overall wider range and of 4.5 per cent in place of the earlier narrow 2 per cent band range. It was argued that the introduction of a wider band would help equilibrium capital flows while discouraging the disequilibrating speculation. It would also enable the Fund

members to exercise a greater degree of freedom in the use of monetary policy than was possible in the past while still preserving some of the anti inflationary effects of the fixed foreign exchange rates.

The creditor faces the hazard resulting from exchange rate fluctuation causing depreciation of the borrower s currency in relation to lender"s currency. Even when the loans are contracted in lending country"s currency, fluctuating exchange rate increase the creditor faces the hazard resulting from exchange rate fluctuations causing depreciation of the borrower"s currency in relation to lender"s currently. Even when the loans are contracted in lending country"s currency, fluctuating exchange rate increases the hazard for the debtor country in so far as the depreciation of her currency increase the burden of her external debt servicing.

To conclude, some degree of exchange rate stability is essential for the smooth working of world"s economy. Perhaps the causing another round of the inflationary process to start, Furthermore, if a country does not promptly adopt a monetary policy aiming at economic stability, the movements of her fluctuating exchange rate are likely to be oscillations not around a stable value but around a declining trend.

Uncontrolled fluctuations in exchange rate are harmful because such fluctuations seriously hamper the flow of long term foreign investments, where foreign loans are contracted in terms of borrowing country"s currency, the creditor faces the hazard resulting from exchange rate fluctuations causing depreciation of the borrower s currency in relation to lender"s currency. Even when the loans are contracted in lending country s currency, fluctuating exchange rate increases the hazard for the debtor country in so far as the depreciation of her currency increases the burden of her external debt servicing.

To conclude, some degree of exchange rate stability is essential for the smooth working of world"s economy. Perhaps the best position is neither a continuously freely fluctuating exchange rate nor a rigidly pegged exchange rate but one which gives freedom to a country to alter her exchange rate when needed within certain well defined limits such that it promotes the development of stable international economic relations.

NOTES

This has been made possible under the IMF scheme where by a system of flexible foreign exchange rate has been promoted.

Snake in the Tunnel

The phrase snake in the tunnel was coined by the experts to demote the plan that aimed at reducing fluctuations among the currencies of member of the European Economic Community. It is the long term aim of the members of the EEC to form a monetary union by either adopting a common currency or by eliminating the exchange rate fluctuations between the currencies or by eliminating the exchange rate fluctuations between the currencies of member countries currencies was, in fact, suggested by EEC commission as early as 1962 but little was done by way of taking some effective action in evolving a common exchange rate policy. With the completion customs union around 1969 it was felt that a new impetus was needed for the further integration and development of the Community.

At a meeting of the heads of states held of states held in the Hague in December 1969, it was decided that the Council of Ministers, in cooperation with the EEC Commission, should prepare a plan for the establishment of an economic and monetary union. The Werner Report in 1970 concluded that a phased achievement of monetary union during the 1970s would require the reduction and eventual elimination of exchange rate fluctuations between member countries currencies and complete freedom of capital movements among the member states.

In the spring of 1971, the Council Ministers urged that the member central banks should reduce from 15 June, 1971 the margin of exchange rate fluctuations around a community level for the US dollar from the then prevailing 0.75 percent to 0.60 percent. The community level being agreed from time to time among the member countries. The meant reducing the potential spread between two community currencies from 1.5 per cent to 1.2 per cent. The implementation of this plan was however, thwarted by the exchange market developments during mid-1971. in May 1971, the Deutsche mark and the Netherlands guilder were allowed to float in the exchange markets. Subsequently following the suspension of the dollar convertibility in August, the community members

(with the exception of France) permitted their currencies to float in the exchange markets. The Benelux countries, however, agreed to limit the spread between their currencies to 1.5 per cent on either side of the cross parity rate.

The December 1971 Smithsonion Agreement which ended the temporary floating of exchange rates, increased the bands around the par values from 1 per cent to 2.25 per cent. This widening of the bands had two effects. Firstly, it reduced the need for exchange stabilization account intervention in the currency markets as the currencies could move away from their par values without requiring official action. Secondly the wider bands permitted greater price effects on exports and imports because if on currency appreciated to its upper band while the second currency depreciated to its lower band the total price change could amount to 4.5 per cent. A change of this size was likely to influence the level of trade between the two nations.

5.3.8 Following establishment of an appropriate unitary exchange rate system.

The second example of Fund s acceptance of floating exchange rate in exceptional circumstance is that of Canada. The Canadian dollar floated in the foreign exchange market for about 12 years from September 1950 to May 1962. the fluctuating exchange rate was introduced to dampen a heavy inflow of the US capital funds which had become indeed massive 1950 adding to the money supply, depressing the interest rates and augmenting inflationary pressures in country of the fluctuating currency of specified days. Computations under the decision have been made only for those countries for which transactions no; longer take place at their par values.

In a second et of circumstances, the Fund has gone some what further, in conjunction with exchange reform and stabilization, the Fund has supported programmers, which have included a fluctuating exchange rate. To some extent, Peru"s fluctuating exchange rate had been introduced as part of an exchange reform. The problem of speculative capital movements under fluctuating foreign exchange rates in turn creates the more difficult problem of an unusually high liquidity preference. The gain and losses which can be made from unexpected depreciation of one currency or another have come to be realized more and more widely. People, therefore try to invest

their money in and liquid form as possible, in order to be able to convert it at the first sight of danger into some other currency which appears at the moment to offer greater security. This phenomenon of very high liquidity preference encourages hoarding and causes the rate of interest to raise leading eventually to deadline in investment, employment and income in the economy.

5.4 NEW EXCHANGE ARRANGEMENTS

Under the amended Articles of Agreement of the Fund that because effective from 1 April, 1978 each member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustments or to gain an unfair competitive advantage over other members. Under the international monetary reforms there is provision for the Fund to deterging by a high majority of 85 percent of total voting power for introduction of a widespread system of exchange arrangements based on stable but adjustable par values. A member is free to establish of not to establish a par value for its currency. If a member however, establishes a par value for its currency such a par value can be established in terms of the special drawing right or in terms of such other common denominator as is prescribed by the Fund. The common denominator shall not be gold or currency. A member that does not establish a par value for its currency shall consult with the Fund and ensure that its exchange arrangements are consistent with the purposes of the Fund and are adequate to fulfill its obligations under Article IV, Section I. the Fund shall exercise surveillance over the exchange arrangements by overseeing the international monetary system in order to ensure its effective operation. The maximum and the minimum rates for spot exchange transactions taking place within the territories of a member that has a par value for its currency between it currency and the currencies of other members maintaining par values shall not differ from parity by more than 4.5 per cent or such other margin as may be adopted by the Fund.

5.4.1 Spot and Forward Foreign Exchange Rates

There are spot rate of exchange and the forward rate of exchange ruling in the foreign exchange markets. The spot rate of exchange is the rate or price expressed in

terms of the home currency which is payable for spot delivery of a specified type of foreign exchange. The forward rate of exchange the rate or price at which a transaction will be consummated at some specified time in future. In actual practice, there is not one but many spot rates of exchange, the spot rate for cables (telegraphic transfers) being different (usually higher) from the one applicable to cheques and commercial.

In modern times the system of forward rate of exchange has assumed great importance in affecting the international capital movements and foreign exchange banks play an important role in this respect by matching the purchases and sales of forward foreign exchange on the part of would be importers and would be exporters respectively. The system of forward exchange rate has actually been developed to minimize risks resulting from the possibility of fluctuations over time in the spot exchange rate to importers television dealer in India wants to import television sets from Japan. Suppose that a television dealer in India wants to import television sets from Japan. Suppose that the spot exchange rate at the moment is Rs.2 per Japanese yen and at this rate the Indian televisions dealer calculates that they could import the television sets, pay the customs duty on them, sell them in India, pay the price of the television sets and make a profit on them. But by the time the television sets have been shipped across the ocean, released in Mumbai, sold and paid for, several months will have collapsed and the exchange rate may now be Rs.3 for a yen in which case he has to pay one rupee more for each yen of the yen price of the television set and in place of expected profit he may realize actual losses. In other words, the transaction will be profitable only if the Indian importer can import television sets at an exchange rate of two rupees for one, Japanese yen.

The forward exchange rate market gives him this assurance. His bank will sell him there month"s forward yens at Rs.2 per yen by charging a slight premium. This means that the bank undertakes to sell the named quantity of the yeans at an exchange rate of Rs.2 per yen in three months time, whatever the rate of exchange in the foreign exchange market may be when that times comes, Similarly, persons who expect to receive sums in foreign currency at future dates (i.e., exporters or investors expecting interest from abroad on their investments) are able to sell forward exchange to the banks in order to be sure in advance exactly how much they will receive in terms of the home

currency. The basic importance of the forward rate of exchange flows from the fact that the actual rate of exchange is liable to fluctuate from time to time rendering the purchase and sale of goods abroad risky. Forward foreign exchange rate enables the exporters and importers of goods to know the price of their goods which they are about to export or import.

5.4.2 Arbitrage

An arbitrageur is a dealer or trader under who by taking advantage of inconsistencies in the buying and selling prices quoted in different parts of the foreign exchange market makes profit, Unlike the risky activities of a speculator, the activities of an arbitrageur are free from exchange risk because he never takes an uncovered position in the foreign currency. The arbitrageur may trade either in sport or in forward foreign exchange or he may even simultaneously trade in both the sport and forward foreign exchange.

Arbitrage is simultaneously buying a currency is on market and selling it in another at a small margin of profit which results from inconsistencies in foreign exchange rates in different parts of the market. It is the mechanism by which two foreign markets, physically separate, are unified into a single market in an economic sense. A single market is a place where the buyers and sellers of a commodity trade it at an identical price. Where the same price exists continuously for the commodity, there exists one market for that commodity. Arbitrage produces one price and one market where there are two markets and the costs of buying in one and selling in the other are small where arbitrage takes are two markets and the costs of buying in one and selling in the other are small where arbitrage takes place in the foreign exchange market it is among the most perfect markets of the world because money is the most homogeneous of all goods and it can be transferred instantaneously.

Arbitrage in foreign exchange may be either spot arbitrage or forward arbitrage. If the spot price of pound sterling is $ 4.00 in New York and $ 4.05 in London, profit can be earned without involving any risk by simultaneously buying pound sterling in New York and selling these in London, in the case of forward arbitrage, if the dollar is at a

forward discount of 1 per cent in New York and 2 percent in London. The forward arbitrage and the profit on arbitrage will persist until the discount in New York and London foreign exchange markets becomes equal. However unlike spot arbitrage where the arbitrageur realizes his profit without any time loss, in the case of forward exchange arbitrage, the arbitrageur will realize his profit only on the expiry of the period of the contract, in the way the arbitrage operations unify prices in the two markets.

5.5 BASIC CONCEPTS OF FOREIGN EXCHANGe

5.5.1 Foreign Exchange – Meaning

The term „foreign exchange" is popularly referred to as the currencies of other countries. To an Indian, US $ is a foreign currency just as Indian Rupee is to an American. X, an Indian receives a remittance (say) US $ 100 from his relative in California. X cannot make use of this foreign currency in its original from, for (US $) has to be converted into Indian Rupees before being made effective use of. Similarly, an Indian desirous of making a remittance of (say) Great Britain Pounds (GBP) 150 to institute of Bankers, London, has to get the Rupee converted into GBP before being remitted abroad:

Thus, Foreign Exchange may be defined as:

i. the currencies of other countries in the form of currency notes, drafts, TCs, etc.,

ii. the method/mechanism by which currency of one county is converted into that of another

Check Your Progress

5 Define Foreign Exchange.

5.5.2 Need for conversion

Any county, developed or developing, needs to go beyond its territories and trade with other countries, whereas currency of each county is legal tender only within their national boundaries.

Secondly, when countries trade there is no single Universal Currency in which the settlement can be made. The payment has to be effected either in the currency of the

buyer or the seller or in a mutually accepted third currency. This necessitates the conversion of one currency into another.

5.5.3 Exchange Control

The need for control arises, when any commodity is in shortage, i.e., when its demand exceeds it supply.

In India Foreign Exchange is demanded for meeting the country"s import requirements, debt servicing and loan repayment whereas its supply comes from export proceeds, invisible receipts Non-Resident deposits, foreign assistance and loans.

Our regular inward receipts (supply) of foreign exchange is much lower compared to the demand for it, necessitating the country to go for external borrowings to balance its external payment position Foreign exchange is therefore, a scarce commodity and to ensure it judicial use, Government of India monitors and controls foreign exchange through RBI under powers derived from Foreign Exchange Regulation Act (FERA) 1973. the control so exercised is known as Exchange Control.

5.5.4 Role of RBI and others

Under the FERA 1973, RBI administers the exchange control. But RBI seldom does any exchange business with public. Therefore RBI has authorized certain banks by granting licenses to handle the actual transactions (deal). Such banks are called Authorized Dealers.

With a view to offer money changing facilities to tourists and travelers RBI has granted licenses to reputed hotels and establishments to handle a limited variety of foreign exchange transactions, viz., and encashment of traveler"s cheques and purchase/sale of foreign currency note/coins. These organizations are termed as Authorized Money Changers (AMCs). There is no need for all the AMCs to transact both purchase and sale of foreign exchange. As in the case of hotels and reputed shops, there would be a need for some establishments for purchase foreign currency notes and travelers cheques. Such establishments are granted licenses for purchase alone and not

for sale. They are called Restricted Money Changers (RMC). On the other hand, for certain other establishments like exchange bureaus functioning at airports etc., there is a need for both purchases as well as sales. Hence, there are granted licenses for both purchase and sale transactions. They are 5.).

To ensure that all those handling exchange business observe norms and producers uniformly, RBI has delegated powers to Foreign Exchange Dealers Association of India (FEDAI) to frame guidelines for their strict observance. FEDAI frames rules regarding exchange rates, fixed service changes, provides guidelines and also cautions that Ads (wherever warranted) in respect of all foreign exchange transactions.

5.5.5. Authorized Dealer's authority

Though Ads are empowered to handle foreign exchange transactions, it should hold authority from RBI to hands each transaction. Reserve Bank has delegated powers to ADs to handle select types of transactions. We call it „Ads" delegated authority. For handling transactions not specified under Ads delegated authority, ADs MUST obtain specific sanction from RBI.

The specific of the delegated powers are provided in the Exchange Control Manual. Any change/modification in the provisions in the Manual is advised from time to time from time to time from RBI through „AD Series" circulars.

Check Your Progress

6 FFMC stands for

5.6 FOREIGN EXCHANGE TRANSACTIONS

Transactions that result in conversion of one currency into another are termed as foreign exchange transactions. When an AD converts foreign currency into India rupees, he acquires that foreign currency and parts with equivalent India Rupees. This transaction is known as purchase transaction.

When AD converts Indian Rupees into foreign currency he acquires Indian Rupees but parts with equivalent foreign currency. This is called sale transaction.

Hence,

In purchase transactions – Authorized Dealer acquires foreign exchange and parts with Indian rupees

In sale transactions – Authorized Dealer takes Indian Rupees and parts with foreign exchange.

Settlement of foreign exchange transactions NOSTRO, VOSTRO & LORD Accounts

When a cheque or an export bill in foreign currency (say US $ 10,000) is purchased by the AD (say IOB) he forwards the instrument/documents to his foreign correspondent credits the proceeds to an account maintained by the AD (IOB) with the correspondent. Similarly when IOB issues a draft for US $ 5,000 on its correspondent (says Bankers Trust Company, New York) the drawee bank honours the draft to the debit of IOB"s account with them.

The account maintained by an AD with its correspondent abroad is termed by it as its NOSTRG ACCOUNT meaning „our account with you"

Foreign correspondents also maintain Rupee Accounts with Banks in Indian such accounts or referred to by us as VOSTRO ACCOUNTS meaning „your account with us". For instance, Abu Dhabi Commercial Bank, Abu Dhabi, maintains a Rupee account with IOB Chennai.

Thus foreign exchange transactions are settled by entries in bank accounts maintained at select foreign centers. There is no physical transfer of funds from one centre/bank to another.

Just as IOB has a NOSTRO account with BTC, New York, Indian Bank may also have a NASTRO account with them. When IOB instructs to BTC, NEW YORK soliciting transfer of funds to Indian Bank"s account with them, Indian Bank"s titled as LORD ACCOUNT meaning „their account with you".

5.6.1 Foreign Exchange Market

Like any other commodity, foreign exchange also has an active (global) market. It has a three tier market consisting of the following segments.

a) MERCHANT MARKET – comprising of all ADs and their export-import customers and other clients concerned with non-export/non-import foreign exchange transactions.

Merchant transaction if put through immediately is called SPOT transaction. Merchant transaction which to be put through at a future date/future period is called – Forward transaction.

b) INTER-BANK MARKET – constituted by banks in India, including RBI, dealing in foreign exchange. This market helps ADs to exchange their surplus and to undertake suitable cover operations. Inter Bank transaction when put through on

1) Same day is called - Cash transaction

2) Next working day is called - Tom transaction

3) Third working days is called - Spot transaction

4) Future transaction - Forward transaction

c) INTERNATIONAL MARKET – comprising of all banks dealing in foreign exchange at select international center like London, Singapore, Hong Kong, New York, Tokyo. When and AD has committed to his customer a large sum of foreign currency of the AD has large sum of foreign currency and is unable to cover these short-age/excess position as the case may be in India in the inter bank market they approach international market to arrange for funds of to cover operations of the excess position they have at point of time through international market abroad, say in Singapore or London.

Special features of FERA

a) The provisions of FERA extend to the whole of India, has also to all Indian citizens and Indian entities outside India.

b) Where any person is prosecuted against for contravening certain in provisions of FERA, the

c) The penalties for FERA violations are stricter.

5.6.2 Foreign Exchange Dealer' Association of India

FEDAI was established in 1958 as an associated of all authorized dealer in India. All authorized dealers, currently numbering over 70, are its member. It has its headquarters at Mumbai and local offices at Bangalore, Calcutta, Chennai and New Delhi. The affairs of FEDAI are managed by a Managing Committee at the Head office and Respective Local Committee at local offices. The Committees are represented equally by banks incorporated in India and outside India.

The principal functions of FEDAI are

To frame rules for the conduct of foreign exchange business in India. These rules cover various aspects like hours of business, charges for foreign exchange transactions, and quotation of rate to customers, inter bank dealings, etc. All authorized dealers have given undertaking to the Reserve Bank t abided by these rules. Provisions of FEDAI rules have been considered at appropriate places in the relevant chapters of this book.

To coordinate with Reserve Bank of India paper administration of exchange control.

To circulate information likely to be of interest to its members. (Informational trade received from organizations like the International Chamber of Commerce is passed to the members it also act as a clearing house for exchange of information among members.)

Thus FEDAI provide a vital link it the administrative set-up of foreign exchange in India. It is the mouthpiece of the authorized dealers, representing their views to the Reserve Bank and other international agencies.

5.6.3 Authorized Money Changers

To provide facilities for encashment of foreign currency of tourists, etc., reserve Bank has granted limited licenses to certain established firms, hotels and other organizations permitting them to deal in foreign currency notes, coins and travelers" cheques subject to directions issued to them from time to time. These firms and organizations are called „authorized money changers". An authorized money changer may be a „full-fledged money changer" or a „restricted moneychangers". A full-fledged money changer is authorized to undertake both purchase and sale transactions with the public. A restricted money changer is authorized only to purchase foreign currency notes, coins and travelers" cheques subject to the condition that all such collections are surrendered by him in turn to an authorized dealer in foreign exchange.

5.7 SUMMARY

This theory has a practical significance from the point of view monetary policy. It warns countries that there are certain things which they cannot do. In May 1924, England fixed the gold value of the pound-sterling higher than was justified by the prices in prevailing at that time in the country. According to the theory, the high exchange value of the pound-sterling could be maintained only if prices in England were lower relatively to world prices. Failing that fact the foreign exchange rate of the pound-sterling would have to fall. Government, however, tried to maintain the value of the pound – sterling by raising the discount rate and attracting foreign capital.

5.8 KEY WORDS USED IN THE LESSON

Foreign exchange rate

Balance of payment theory

5.9 ANSWER TO CHECK YOUR PROGRESS QUESTIONS

1. Inconvertible currency

2 Same

3 John Wheatley

4 Foreign exchange rate

5 Foreign Exchange may be defined as:

The currencies of other countries in the form of currency notes, drafts, TCs, etc.

The method/mechanism by which currency of one county is converted into that of another

6 Full Fledged Money Changers

5.11 MODEL QUESTIONS

1. What do you understand by Purchasing Power Parity Theory?
2. What is stable foreign exchange rate?
3. What is meant by flexible foreign exchange rate?
4 What do you understand by spot transaction rates?
5. Explain briefly about Authorized Money changers.
6. Explain in detail about the various important theories in foreign exchange rate.
7. Explain the basic concepts of foreign exchange.

5.9 Further reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of For eign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

UNIT- VI

EXCHANGE CONTROL IN INDIA

NOTES

UNIT STRUCTURE

6.1 Introduction

6.2 Unit Objectives

6.3. Foreign Exchange Regulation Act

6.4 Reserve Bank of India

6.5. International Exchange System Past and Present

6.6. International Exchange

6.7 Exchange Rate Policy

6.8 Summary

6.9 Key words used in the lesson

6.10 Answers to check your progress questions

6.11 Model Questions

6.12 Further reading

6.1 INTRODUCTION

Exchange control was introduced in India on September 3, 1930 on the outbreak of the Second World War by virtue of the emergency power derived under the financial provisions of the Defence of India Rules, mainly to conserve the non-sterling area currencies and utilize them for essential purposes. In the closing stages of the War, it became clear that control over foreign exchange transactions would have to continue in some form or the other in the post-war period in the interest of making the most prudent use of the foreign resources. It was, therefore decided to place the control on a statutory basis and the Foreign Exchange Regulation Act of 1947 was enacted. This Act has since been replaced by the Act of 1973.

It was found necessary to continue exchange control introduced during the Second World War on a systematic and long-term basis, in view of the substantial requirements of foreign exchange for the planned development efforts undertaken. Over the years, the scope of exchange control in India has steadily widened and the regulations have become progressively more elaborate with the increasing foreign exchange outlays under successive. Five-Year Plans and the relatively inadequate earnings of foreign exchange. Periodically, appraisals and reviews of policies and procedures have been undertaken and such modification made as are warranted by changes in the national policies and priorities, and fluctuations in the level of foreign exchange reserves caused by both national and international economic and other developments.

Exchange control in India is administered by the Reserve Bank of India. To a great extent exchange control is related to and supplemented by trade control, which is the responsibility of the Director General of Foreign Trade in the Ministry of Commerce. The trade controls is applied under the Foreign Trade (Development and Regulation) Act, 1992. While trade control is confined to imports and a few exports and imports. Also, while trade control in confined to imports and few exports, exchange control is more comprehensive and covers imports and exports as well as invisible and capital transactions. Close coordination is maintained in the administration of the two controls. The customs authorities have also an important complementary role to play in the administration of certain aspects of exchange control, e.g., valuation of exports, certification or export declaration forms, clearance of unauthorized imports, etc. A close contract is maintained by them with the Reserve Bank;

The present policy of the Government is liberalization in exchange control and opening up of economy to foreign investment and competition. The process of liberalization has begun with the announcement of the changes in Trade Policy in July 1991.

6.2 UNIT OBJECTIVES

1. To study the foreign exchange control

2. To identify the procedures followed in controlling foreign exchange

3. To find the steps taken by the government in controlling foreign exchange

6.3 FOREIGN EXCHANGE REGULATION ACT, 1973

NOTES

The foreign Exchange Regulation Act, 1973, came into force on January 1, 1974. the purpose of the enactment is to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export of currency and bullion, for the conservation of the conservation of the foreign exchange resources of the country and the proper utilization thereof in the interest of the economic development of the country.

Check Your Progress

1 Foreign Exchange Regulation Act was passed in the year _____ 1973

6.3.1.1 The following transactions are covered by FERA, 1973

Dealings in foreign exchange: Except for authorized dealers, other persons can deal in foreign exchange only with the permission of the Reserve Bank. The conversion of foreign currency into Indian currency and vice versa shall be done at rates as authorized by the Reserve Bank (sec.8)

Payment in/Receipt of foreign exchange: Receiving of payment on non-residents and payments to non-residents except through authorized dealers and in accordance with any general or special exemption given by Reserve Bank is restricted (sec.9). The exemption given by Reserve Bank may require the amount to be placed in a blocked account (sec.10).

Imports and Exports of currency and exchange: Bringing or sending into India any Indian currency of foreign currency/exchange except under the permission of the Reserve Bank is prohibited. This does not apply to foreign exchange obtained from an authorized dealer on money changer (sec.13).

Payment for exported goods: Full value and other details of exported goods should be furnished by exporter to the prescribed authority. The exporter is responsible for receipt into India of the full export value of the goods. The method of sale and other matters relating to exports are government by notifications of Reserve bank and Central government (sec.18). Goods shall not be taken out of India on hire

or lease or any arrangement other than sale except with the general or special permission of Reserve Bank (sec.18A).

Issue, export and transfer of securities: Issuing of India securities to non-residents transfer of securities to non-residents and sending of securities also requires Reserve Bank permission (sec. 22).

Settlement/Gift by residents: No resident shall make a gift of or settle any property in India to a non-resident, without permission of the Reserve Bank (sec. 24).

6.3.1.2 Holding of immovable property outside India by resident:

No person resident in India shall, except with the general or special permission of the Reserve Bank, acquire or hold or transfer or sell or charge any immovable property situated outside India. This is not applicable to foreign nationals (sec. 25).

Employment/appointment of non-resident: a person non-resident in India, a foreign national in India, a foreign company and a FERA company can act or accept appointment in India as agent only with the permission of Reserve Bank. No foreign national can practice any profession or carry on any occupation, trade or business in India without the prior permission of Reserve Bank (sec. 28 and 30).

Establishment of place of business in India: a non-resident cannot carry on business in India or acquire a part or whole of an undertaking in India without the general or special permission of Reserve Bank (sec. 29).

Acquiring immovable property in India by foreign national: A foreign and foreign company shall not acquire or hold or transfer or change any immovable property situated in India without prior permission of the Reserve Bank (sec. 31).

For enforcing the provisions of the Act and dealing with proseculation and adjudications for evasion or contravention of the regulations, there is separate machinery, viz., the directorate of Enforcement in the Central Government, with headquarters in New Delhi and branch offices situated in important places in the country.

As a part of the process of liberalization, a completer review of the Foreign Exchange Regulation act is under the active consideration of the Government foreign Exchange Regulation (Amendment) Ordinance, 1993, deleted nine sections, amended nineteen sections and added two new sections t FERA. The changes have been considered in providing the summary above.

6.3.1.3 Administration of Foreign Exchange

Under the Foreign Exchange Regulation act, the responsibility and authority of administration of foreign exchange is vested with the Reserve Bank of India. The Central Government has been empowered to make rules under the Act and give to Reserve Bank such general or special directions as it thinks fit. The Reserve Bank must comply with such directions (sec. 75). The Reserve Bank has also been vested with wide powers to enable it to discharge its responsibilities under the Act. Any person who deals with foreign exchange has to abide by the directions given by the Reserve Bank in that behalf.

While the Reserve Bank has full authority to administer foreign exchange in India, it is recognized that it cannot do so by itself. Foreign exchange is received or required by a large number of exporters and importers and importers in the country spread over a vast geographical area. It would be impossible for the Reserve Bank to deal with them individually. Therefore provision has been mad in the Act (sec. 74), enabling the Reserve Bank to delegate its powers of functions, with the prior approval of the Central Government, to others. The person to whom the power, functions and delegated may be authorized dealers or authorized money changers.

6.3.1.4 Authorize Dealers

A major portion of actual dealing in foreign exchange from the customers (importers, exporters and other receiving or making personal remittances) is dealt with by such of the banks in India which have been authorized by the Reserve Bank to deal in foreign exchange. Section 6 of FERA states that the Reserve Bank may, on an application made to it in this behalf, authorize any person to deal in foreign exchange. However, authorization in the form of license to deal in foreign exchange is ordinarily granted only to scheduled banks in India. Authorizations have also been granted to

certain finance institutions to undertake specific types of foreign exchange transactions incidental to their main business.

The Reserve bank may refuse to grant authorization if in its opinion the applicant is not properly equipped or otherwise unfit to undertake foreign exchange business. Similarly, the license already granted may be revoked if it is in public interest or if the authorized dealer has not complied with the condition subject to which the authorization dealer has complied with the conditions subject to which the authorization was granted or has contravened any of the provisions of foreign exchange regulations.

An authorized dealer should comply with the directions and instructions of the Reserve Bank given from time to time. The Exchange Control Manual (latest 1993 edition) embodies such directions of standing nature issued by the Reserve Bank to authorized dealers. All amendments to the Exchange Control Manual are intimated to authorize dealer by the Reserve Bank in the form of its AD (MA Series) circulars. Further, general and procedural directions are given in the form of it AD (GP Series) circulars. Thus in carrying out its dealings, an authorized dealer should be guided by the latest edition of the Exchange Control Manual, as amended up-to-date by AD (MA Series) circulars.

Check Your Progress

2 FEDAI stands for

The FERA states that an authorized dealer shall, before undertaking any transaction in foreign exchange on behalf of any person, require that person t make such declarations and give such information as will reasonably satisfy that the transaction will not be in contravention or evasion of foreign exchange regulations. The authorized dealer should effuse to undertake the transactions if the condition is not complied with. If the authorized dealer believes that the other person contemplates any contravention or evasion of foreign exchange regulation, the matter should be reported by the Reserve Bank.

With regard to charging of commission, quotation of rates, etc., the authorized dealer should also comply with the rules of Foreign Exchange Dealers Association of India (FEDAI).

6.4 THE RESERVE BANK OF INDIA

NOTES

6.4.1 Functions of the Reserve Bank of India

The Reserve Bank of India (RBI) was set up in April 1935 with a share capita of Rs. 5 corers, divided in shares of Rs. 100 each fully paid up. The Bank was nationalized in 1949. The functions the Reserve Bank performs are of three types: central banking functions, supervisor functions, and promotional functions.

A. Central Banking Functions: Monetary Functions.

(i) Bank of Issue: The Reserve Bank of India has the sole right to issue bank notes of all denominations. The Reserve Bank has a separate issue Department which is entrusted with the issue of currency notes. Since 1957 the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold. The system of note issue as it exists today is known as minimum reserve system.

(ii) Government Banker: The Reserve Bank of India acts as Government banker, agent and adviser. The Bank has the obligation to transact Government business, viz., to keep the cash balances as deposit free of interest, to receive and to make payments for the government and to carry out their exchange remittances and other banking operations. It helps the Government – both the Union and this States – to float new loans and manage public debt. The bank makes ways and means advances to the Government for 90 days. It makes loans and advances to States and local authorities. RBI advised the government on all monetary and banking matters – on the floating of loans, on agricultural and industrial finance, on legislation affecting banking and credit, on financial aspects of planning, etc.

(iii) Bankers' Bank and Lender of the Last Resort: RBI acts as the banker's bank. According to the provisions of the RBI Act, 1934, every scheduled bank was required to maintain with RBI a cash balance equivalent to 5 per cent of its demand liabilities and 2 per cent of its time liabilities in India. This provision helps to centralize the banking reserves of the country. The

scheduled banks can borrow from RBI on the basis of the eligible securities or get financial accommodation in times of need or stringency by rediscounting their bills of exchange. Since commercial banks can always expect RBI to come to their help, RBI is not only the bankers' bank but also the lender of the last resort. Under the Banking Regulation Act of 1949, RBI has considerable powers of supervision and control over the banking system – in issuing licenses to banks, giving permission to open branches, etc.

(iv)Controller of Credit: RBI is the controller of credit, i.e., it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank Rate or through open market operations. According to the Banking Regulation act of 1949, RBI can ask any particular bank or the whole banking system not to lend to particular groups of person or on the basis of certain types of securities. Since 1950, selective controls of credit are increasingly being used by RBI.

Check Your Progress

3. The controller of credit is _____.

(v) Custodian of Foreign Exchange Reserves: RBI has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required India become a member of the International Monetary Fund. RBI has the responsibility of maintaining fixed exchange rates with all other member-countries of the IMF. RBI buys and sells foreign exchange from authorized persons at rates of exchange fixed by the Government. Besides maintaining the rate of exchange of the rupee, RBI holds India's reserves of International currencies. Finally, RBI administers exchange controls of the country.

B.Non-monetary Functions

(i) Supervisory Functions

In additions to its traditional central banking function, RBI has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949, have given RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishment, branch expansion, liquidity of their assets, management and methods of working, amalgamation, re-

construction, and liquidation. RBI is authorized to carry out periodical inspections of the banks and to cal for returns and necessary information from them. The nationalization of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives. The supervisory functions of RBI have helped a great deal in improving the standard of banking in India t develop on sound lines and to improve the methods of their operation.

(ii) Promotional Functions

With economic growth assuming a new urgency since independence, the range of RBI's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which at one time were regarded as outside the normal scope of central banking. RBI was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, RBI has helped in the setting up of IFCE and SFCs; it set up the Deposit Insurance corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963, the Industrial Reconstruction Corporation of India in 1972 and NABARD in 1982. These institutions were set up directly or indirectly by RBI to promote saving habit and to mobilize savings, to provide industrial finance as well agricultural finance. From the very beginning, RBI has set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. RBI has developed the rural co-operative credit movement so as to eliminate moneylenders. The ARBI set up the Agricultural Refinance and Development Corporation 9ARDC) to provide long-term finance to farmers.

Classification of RBI Functions

The monetary functions also known as the central banking functions of RBI are related to control and regulation of money and credit, i.e., issue of currency, control of bank credit, control of foreign exchange operations, banker to the

Government and to the money market. Monetary functions of RBI are significant as they control and regulate the volume of money and credit in the country.

Equally important, however, are the non-monetary functions of RBI in the context of India's economic backwardness. The supervisory functions of RBI may be regarded as a non-monetary function (though many consider this a monetary function). The promotion of sound banking in India is an important goal of RBI and towards this end RBI has been given wide and drastic powers under the Banking Regulation Act of 1949 – these powers relate to licensing of banks, branch expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation. Under RBI's supervision and inspection, the working of banks has greatly improved. Commercial banks have developed into financially and operationally sound and viable units. RBI's powers of supervision have now been extended to non-banking financial intermediaries.

Since independence, particularly after its nationalization in 1949, RBI has followed the promotional functions vigorously and has been responsible for strong financial support to industrial and agricultural development in the country.

6.4.2 Monetary policy of the Reserve Bank of India

We have explained the objectives of monetary policy of central banks everywhere in the last many decades. What are the objectives of monetary policy of RBI?

In accordance with general tradition of the 1930's, RBI started with a cheap money policy and had fixed a low Bank Rate, viz., 3 per cent. Between 1935 and 1951, there was no change in the Bank Rate in India in spite of the fact that the economy was subject to continuous stress and strain. However, in November 1951, RBI raised the Bank Rate from 3 to 3.5 per cent. This signified a return to an actives monetary policy.

6.4.2.1 Policy of controlled Expansion, 1951-74

With the Introduction of the five-Year Plans in 1950-51, the need for an appropriate monetary policy to suit the pace and pattern of planned development in

India become necessary. RBI, as the monetary authority of the country, was asked to carry out two objectives since 1952:

(a) To provide necessary finance to the private sector, through commercial banks and co-operative banks, for economic development; and

(b) To control the inflationary pressure generated in the economy as a result of vast development expenditure.

The monetary policy of RBI between 1951 and 1974 may be termed broadly as one of controlled expansion, i.e., a policy of "adequate financing of economic growth and at the same time ensuring reasonable price stability". Expansion of currency and credit was essential to meet the increased demand for investment funds in India. The Reserve Bank fully recognized and appreciated the need for expansion of credit and money supply commensurate with the rapid development and diversification of the economy. At the same time, RBI was equally aware that an excessive expansion of money and credit under conditions of inelastic supply would be clearly inflationary and would ultimately endanger the financial stability of the economy.

In order to carry out its monetary policy, RBI was provided with certain weapons of instruments. These were known as weapons of credit control. During this period, RBI adopted two sets of measures:

(a) Measures for expansion of currency and credit for trade and industry by i(i) supplying additional funds to commercial banks, (ii) supplying credit to such special groups like agricultural co-operatives, (ii) providing refinance and discounting facilities for food procurement, export credit, etc., and (iv) setting up special institutions to provide credit to industry such as IFCI, SFCa, ICICI, IDBI, Agricultural Refinance and Development corporation (ARDC, later called NABARD), and so on.

(b) Measures for controlling credit, so as to prevent the economy from experiencing the effects of inflation. This was sought to be achieved through the traditional quantitative controls of bank rat and reserve ratio requirements and the modern selective controls.

Till the beginning of the 1970's, both the above measures were necessary. But there were difficulties and contradictions involved in using these measures. The first set of measures had the effect of expanding the economy while the second set of measures had the effect of controlling the economy – in other words, they were similar to "accelerating" on the side and "applying the brakes" on the other. The monetary policy of controlled expansion was indeed a difficult policy to follow and implement.

6.4.2.2 Anti-Inflationary Monetary Policy since 1974

Since 1972, the Indian economy has been working with considerable inflationary potential. Because of continuous deficit financing by the Government, there was considerable increase in money finance trade and industry. Finally, a number of financial institutions has come up offering funds for investment. Expansion of credit was, therefore, no problem. But the real problem was the inflationary situation that was emerging because of these factors and also because of the global inflationary situation directly due to hike in oil prices. Hence, RBI was forced to abandon "controlled expansion" and adopt the policy of credit restraint. RBI has followed this kind of monetary policy with varying degrees of success, till today.

6.4.2.3. Control of Inflation and Credit control weapons of the Reserve Bank of India

In the previous section, we have explained how in the last three decades, India has been fighting to control the ever-pressing problem of rising prices, RBI has been using specific credit control measures to check the inflationary risse in prices. In this section, we shall briefly describe these methods.

(a) Bank Rate Policy

RBI is the lender of the last resort to the banking system and, therefore, the rate at which it gives accommodation to the latter assumes great importance. The RBI influences the cost and availability of credit to the scheduled banks through its Bank Rate – the standard rate at which the RBI is prepared to buy or rediscount bills of

exchange or other eligible paper; but for all practical purposes, the Bank rate is the rate charged by the RBI on its advances to the scheduled banks.

Since 1951 the RBI has changed and adjusted the Bank Rate with a view to influence the level of business and industrial activity in the country and particularly to control the inflationary pressure. The Bank Rate was raised from 3 to 3.5 per cent in February 1951, and it was raised gradually to 9 per cent in July 1974 and 10 per cent since July 1981 and to 12 per cent since October 1991. The Bank Rate is significant as it is the "pace-setter to the other market rates, including the lending rates of commercial banks are adjusting themselves almost automatically to changes in the Bank Rate. The Stepping up of the Bank Rate and the consequent rise in the lending rates of the commercial banks have been used to reduce bank credit to speculative transactions and contain inflationary pressure.

The Bank Rate is also connected to the deposit rates of the scheduled banks. Accordingly, when the Bank Rate is raised, the deposit rates of banks are also raise, including the general public to increase their savings. The too has anti-inflationary impact.

There is, however, one serious problem in raising the bank rate and other lending rates, that is, bank credit to finance investment may be curtailed and real output may be checked. This will push inflationary pressure.

(b) Case Reserve Ratio (CRR)

Another weapon used by RBI for credit control is known as the statutory cash reserve ratio (CRR). We have explained earlier how under RBI Act, 1934, every scheduled bank has to keep certain minimum cash reserve with RBI; initially, it was 5 per cent against demand deposits and 2 per cent against time deposits. By an amendment of 1962, RBI was empowered to vary the cash reserve ratio between 3 per cent and 15 per cent of the total demand and time deposits. During 1973, RBI exercised this power twice, as a form of credit squeeze – the statutory cash reserves were raised from 3 to 5 per cent in June 1973 and to 7 per cent in September 1973. The CRR was raised subsequently to the maximum of 15 per cent, part of the overall strategy of demand management.

Check Your Progress

4 _____ is connected to the deposit rates of the scheduled banks.

5 The statutory cash reserve ratio (CRR) is the weapon used by RBI for

The CRR was changed later that is – CRR was reduced when there was too much credit squeeze and too much contraction of business conditions in the country (during 1995-96) – CRR was raised when inflationary conditions were intolerable and control of inflation became the number one problem for the country (e.g., in 1994-95).

Incremental CRR

When the normal CRR does not succeed in containing inflationary pressure, RBI may be forced to adopt more stringent measures. In May 1991, the inflation was almost getting out of control. Already, RBI directed the scheduled banks to maintain 10 per cent of the incremental (additional) demand and time liabilities as cash reserve ratio. This incremental CRR was in addition to the regular CRR of 15 per cent. Thus the CRR on additional deposits would work out to 25 per cent. In other words, incremental CRR had the effect of impounding 10 per cent of the additional deposits of the banks.

ICRR as also increased or decreased – and even dropped altogether – depending upon the level of inflationary conditions in the country.

(d) Statutory Liquidity Requirements (SLRs)

We have already seen that, apart from statutory cash reserves which scheduled banks have to keep with RBI (under the RBI Act, 1934), all commercial banks have to maintain (under Section24 of the Banking Regulation Act, 1949) liquid assets in the form of cash, gold and unencumbered approved securities equal to not less than 25 per cent of their total demand and time deposit liabilities. This is known as the statutory liquidity requirement.

Maintenance of adequate liquid assets is a basic principle of sound banking. Hence scheduled banks in India have been required by Banking Regulation Act, 1949, to maintain some ratio of liquid assets. RBI was given the power to change the minimum liquidity ratio. Accordingly, RBI raised the liquidity ratio from 25 per cent in November 1972, and 38.5 per cent from January 1988, RBI stepped up the liquidity ratio for three reasons:

(a) A higher liquidity requirement forces scheduled banks to maintain a larger proportion of their resources in liquid form and thus reduces their capacity to grant loans and advances to business and industry – thus it is said to e anti-inflationary in impact; and

(b) A higher liquidity ratio diverts banks funds from loans and advances to industry and trade to investment in Government securities and bonds of public sector financial institutions.

(c) The higher liquidity ratio is a method of raising funds for the Government and for the public sector financial institutions at a rate lower then the market rate interest.

It may be mentioned here that the effect of stepping up cash reserve ratio (CRR) and the statutory liquidity requirement (SLR) is the same, viz., they force banks to keep large volume of funds, in liquid form and thus reduce the capacity of scheduled banks to give credit to business and industry and thus are anti-inflationary.

(e) Selective credit Controls

Before the Banking Regulation Act, 1949 was passed by RBI used mostly traditional or conventional instruments (or quantitative controls) such as the Bank Rate and the open-market operations. Under Section 21 of the Banking Regulation Act, 1949, RBI has been vested with wide powers to control advances by individual banks or by the system as whole. RBI is authorized to issue directives to any bank or the banking system as a whole in regard to:

(i) The purpose for which advances may or may not be made;

(ii) The margins to be maintained on secured loans;

(iii) The maximum amount of advances to any firm or company; and

(iv) The rate of interest to be charged.

At present, advances against (a) food grains, (b) cotton and kapas, (c) oilseeds and oil, (d) vanaspathi (e) sugar, khandsari and gut, and (f) cotton textiles, including yarn, are subject to selective controls. Under the system of selective credit controls,

RBI fixes party wise ceilings on the basis of crop prospects, supply position and price trends. Banks are then required to get the permission of RBI to grant to new borrowers and to increase the credit limits in case of existing borrowers. Without prior permission of RBI, a bank cannot take over a commodity account which is subject to selective credit control from another bank.

Further, in case of advances against commodities subject to selective control, higher margin are prescribed in order to restrict the borrowing capacity of the borrower against the security of the same commodity.

A higher margin is generally fixed for those borrowers whose need for credit may not be so urgent or larger flow of credit to whom is likely to aggravate the price situation. RBI does not allow granting of clean credit facilities to any borrower subject to selective credit controls.

Finally, RBI makes certain exemptions from the use of selective credit controls – for example, such State agencies as the Food Corporation of India and STC are exempted.

(f) Prior Authorization Scheme (PAS)

One form of selective credit control was known as the Prior Authorization Scheme introduced by RBI in November 1965. Under the Scheme, the scheduled commercial banks had to obtain RBI's authorization before of sanctioning any fresh credit limit of Rs.1 crore or more to any single party; under the scheme, RBI required the scheduled banks to collect, examine and furnish detailed data regarding the borrowing concerns. They were also required to ascertain the working of the borrowing concerns on such points as inter-corporate lending or investments, excessive inventory build-up, diversion of short-term funds for acquisition of fixed assets, etc. The purpose was that banks should lend on the basis of credit appraisal and the actual needs of the borrowing concerns.

The credit authorization scheme (CAS) was liberalized periodically. In July 1987, it was liberalized to allow for greater access to credit to meet genuine demands in production sectors without the prior sanction of RBI. But CAS was given up in 1988. However, to ensure that the basic financial discipline continued to be observed

by banks, RBI would monitor and scrutinize all sanctions of bank loans exceeding (a) Rs.5 crores to any single party for working capital requirements, and (b) Rs.2 crores in the case of term loans. The post-sanction scheme has been called as Credit Monitoring Arrangement (CMA).

The scheduled banks have generally conformed to the selective control directives of the Reserve Bank and the advances against particular commodities were maintained with in the permitted limits. In this connection, it is fruitful to quote the Reserve Bank itself: "the success of these controls is to be judged in a limited sphere, viz., their impact on the pressure of demand originating from bank credit; in this sense, the measures should be deemed successful; but for their operations, it is likely that the price situation might have been somewhat worse".

6.4.3 An Evaluation of RBI's Controls

During 1950's and 1960's the monetary policy of RBI had twin aims: expansion o the economy and control of inflationary pressure. Since 1970-71, however, the major objective of monetary policy in India has been the control of inflationary pressure only. But three important observations may be made here;

(i) The weapons and the powers available to RBI are such that they cover only the scheduled commercial banks. To the extent inflationary pressure is the result of bank finance, the Reserve Bank's general and selective controls will have some effect; but if inflationary pressure is really brought about by deficit financing of the Government and shortage of goods, Reserve Bank's control may not be very effective. This is what has been happening probably in the last few years.

(ii) It should always be kept in mind that RBI has no power over indigenous bankers who play such a major role in financing trade and industry.

(iii) RBI's monetary policy is also weak since that extensive use of black money in the country for hoarding and speculative purposes limits the effectiveness of monetary weapons.

6.5 THE INTERNATIONAL EXCHANGE SYSTEM: PAST AND PRESENT

The 1870-1914 gold standard could flourish in an age of creative nationalism, when national self-interest was tempered by a decent respect for would order; gold was accepted as the anonymous monarch and sterling as the power behind the throne, the true international money.

-Robert Mundell

In this chapter, we follow a time line of the international exchange system, from the latter half of the nineteenth century until today. This takes us on a journey though the four principal types of financial systems we have experienced: gold standard, Bretton Woods standard, flexible exchange rates, and cooperative intervention. After the historical tour, we extend the time line into the future by looking at the problems the international financial system faces and how these are likely to affects the evolution of international financial arrangements. We focus on the mounting debt of some key economic player, on the shifting of economic power from the industrial leaders of the twentieth century to a broader base of successful trading nations, and on the direction of the international financial system itself. By analyzing the pros and cons of fixed and flexible exchange rates we are forced to conclude that despite extensive experimentation with different international financial arrangements during this century, there is no obvious, dominant solution. Furthermore, we note that the speed of economic change is likely to place increasing pressure on whatever arrangements are employed.

The Past

6.5.1 The Classical Gold Standard

For almost half a century before the First World War of 1914-1918, the international financial system ran according to the rules of the classical gold standard. The success of this system has been traced to the credible commitment represented by the unconditional guarantee to convert paper money for gold at a fixed price. As we have seen in the preceding chapter, such a commitment is the essential element of the classical gold standard. Few, if any, doubted the willingness of governments to continue to exchange gold for fiat money, even after temporary suspensions during periods of war. Not only did participating countries such as the United States and

France gain the confidence of others, but everybody could count on Britain to do whatever was necessary to underwrite the system.

The criticality of credibility to the success of a rule-based system such as the gold standard has been cast in modern game theory terms, following the successful application of game theory to domestic monetary policy. The key insight is that without rules and a credible commitment to maintain a stable price level, governments can be counted on to say they intend to fight inflation in order to induce people to lend to them at low interest rates, and then afterwards to abandon that promise. The government-induced inflation, in unexpected, reduces the government's real borrowing costs; interest rates would not compensate for realized inflation. However, with rational expectations it is not possible for governments to play this game successfully, Lenders know that the government will misrepresents its intentions, pursuing inflationary policy despite its promises. This drives the economy to an inefficient equilibrium – one in which the public expects the government to defect (that is, to cheat) by inflating and the government knows that the public expects this and does indeed cheat. Therefore, interest rates are high to reflect the expected, and actual, inflation. This is a so-called Nash equilibrium: expectations are consistent and ultimately vindicated, and each "player" chooses the best available action given these expectations. All this follows if governments take no costly steps to gain creditability.

Knowing how the "game" unravels when there is nothing to constrain government behavior, it becomes optimal for the government to agree to a constraint on its behavior. The promise to convert fiat money for gold is just such a constraint and is a signal of its sincerity. In this way gold serves as nominal anchor – a credible commitment to a stable value of fiat money. The public reasons that the government would not agree to a fixed price of gold – or a fixed price of currency versus the U.S. dollar under the Britton Woods system – if it intended to defect. The government knows this and indeed, does not want to defect, instead preferring to keep inflation low even after it has borrowed. In this way the government keeps interest rates low inflationary expectations mean low interest rates.

The Present

If anything is clear from our brief description of the history of the international financial system, it is that it evolves in response to the environment it serves. For example, the shift from the gold standard adopted at Bretton Woods came in response to the beggar-thy-neighbor and protectionist exchange-rate policies of the Depression and war. In reaction to these competitive devaluations, the system that was chosen was characterized by extreme rigidity of exchange rates. With the oil shock of the late 1960s and early 1970s, the rigidity of Bretton Woods could not provide the adjustment needed between oil-using and oil producing nations, and so there followed after 1973 a period of exchange-rate flexibility. With the increasing financial and economic interdependence spawned by financial deregulation and the growth in trade, and with massive structural imbalances of trade and fiscal deficits, the unfettered flexibility of the 1970s and early 1980s was replaced by the more cooperative arrangements of the Plaza Agreement and the Louvre Accord. The obvious question with important implications for the future conduct of international business is, where do we go from here? Since the direction we take is again likely to be a response to current conditions, the answer requires that we identify the problems we face today. These include

1. Shifting global economic power

2. Growing trade imbalances associated with the shift in economic power

3. Increasing environmental concerns relating to international financial and trade flows

4. Need to select and appropriate degree of exchange-rate flexibility.

6.5.2 Convertibility and Inconvertibility

In the present context, of a currency refers to its convertibility into a foreign currency as desired by its holder. The currency is fully convertible if the holder can convert it into any other currency at rates determined by the forces of demand and supply and without any interference from the government. The convertibility therefore involves two aspects:

The rate of exchange should be determined by the market and nor by the regulatory authority and thus the holder does nor incur any loss on conversion; and

There should not be any quantitative restrictions on the repatriation of the currency.

Earlier the exchange rate of rupee was subject to the condition that the rate quoted by a bank to its customer should not be worse than the rate based on RBI rate. Rupee was made partially convertible when dual exchange rate was introduced and 60% of the remittance into India was converted at the market determined rated. Now the value of rupee is fully determined by the market forces. Thus rupee now fulfils the first condition of convertibility, viz., the exchange rate should be determined by market forces.

6.6 INTERNATIONAL EXCHANGE SYSTEM

A currency is converted to effect remittances, either from the country or into the country from abroad. Remittances are broadly classifies into two categories (i) those on current account and (ii) those on capital account. The classification is based on the current and capital accounts in the balance of payments. This classification is based on the current and capital accounts in the balance of payments. Remittance on current account represents transactions relating to trade in goods and services. For such remittances no represents transactions relating to trade in foods and services. For such remittances no reverse flow of funds in the future is anticipated, remittances on capital account relates to investment, plans etc., these represent the external debt of the country and reverse flow in the form of interest/dividend and repatriation of capital is expected.

6.6.1 Current Account Convertibility

Rupee is now fully convertible on current account fulfilling also the second condition for convertibility, viz., no quantitative ceiling on remittances abroad, through subject to certain regulations. As a part of liberalization of foreign exchange transaction, the Reserve Bank has enhanced the discretionary powers for authorized dealers for making various remittances abroad. The limits on remittances for various purposes like travel, studies, medical treatments, gifts, services etc., have become indicative. In certain cases authorized dealers themselves can permit admittance

beyond the indicated limits. In certain other cases, the requests for remittances over the limits shall be referred to Reserve Bank, who will favorably consider the request.

As an affirmation of the convertibility of rupees on current account, with effect from August 20, 1994, India moved over to Article VIII status in the IMF. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions or from engaging in discriminatory currency arrangement of multiple currency practices without IMF approval.

6.6.2 Capital Account Convertibility

The next logical step in the directions is the convertibility of rupee on capital account. In his Budget Speech for 1997-98, the Union Finance Minister described capital account convertibility as the cherished goal of the government. As a follow up measure, the Reserve Bank of India appointed in February 1997 a committee on Capital Account Convertibility (CAC) under the Chairmanship of Sri S.S. Tarapore, then Deputy Governor of Reserve Bank. The committee submitted its report on May 30, 1997.

Benefits of CAC

The Committee has put forward the following as the advantages flowing from CAC: It makes available a large capital stock to supplement domestic resources and thereby enables the economy to register higher growth, reduce the cost of capital and improve access to international financial markets.

It allows residents to holds an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic stocks, lower funding costs for borrowers land prospects of higher yields for savers.

Allocating efficiency improves as a result of financial integration arising from CAC. This can stimulate innovation and improve productivity.

It provides impetus for domestic tax regimes to rationalize land converge to international tax structures. This removes inducements for domestic agents towards evasion and capital flight.

The capital controls turn progressively ineffective, costly and even distractive. On the other hand, an open account would bring the weakness of the Indian financial system under a sharper focus. It would impose a strong discipline upon the financial system and expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading/distribution of risks.

International Experience

The committee made a survey of the international experience in capital account convertibility. The countries which initiate the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shift in a stance of macro-economic policies. Also, these countries were less vulnerable to backtracking and the re imposition of controls. Countries with weak initial conditions were constrained to adopt drastic, macro economic policies to facilitate the move to CAC.

The following are considered important preconditions for CAC

Fiscal consolidations rate The ratio of Center's gross fiscal deficit to gross domestic production to be reduced from a budgeted 4.5% in 1997-98 to 4% in 1998-99 and further to 3.5% in 1999-2000, accompanied by a reduction in the states deficit.

Mandated Inflation rate

The inflation for the three-year period (1997-2000) should be an average of 3-5 per cent.

Strengthening of Financial System

Interest rates should be fully deregulated in 1997-98. The average effective CRR should be reduced to 8% in 1997-98, 6% in 1998-99 and further to 3% in 1999-2000, gross non-performing assets to be brought down to 12% in 1997-98, 9% in 1998-99 and 5% in 1999-2000.

Implementation

CAC should be implemented in three phases over three years: Phase I-1997-98, Phase II - 1998-99 and Phase III – 1999-2000. the implementation of measures

NOTES

contemplated for each phase should be based on a careful and continuous monitoring of the preconditions.

6.7 EXCHANGE RATE POLICY

In the exchange rate policy, the Reserve Bank should have a monitoring band of 5% around the neutral Real Effective Exchange Rate (REER). (REER is the exchange rate for the currency adjusted for inflation rate differential) Reserve Bank should ordinarily intervene as and when the REER is outside the bank.

Adequacy of Reserves

The following four indicators should be for evaluating the adequacy of reserves:

Reserves should not be less than six months of imports.

Reserve should not e less than three months of imports plus 50% of debt service payment plus one month's exports and imports.

The short term debt and portfolio stock shout be lowered to 60%

The net foreign exchange assets to currency ratio should be prescribed by law at not less than 40 per cent.

Narrow banks

The weak banks should be converted into narrow banks and the incremental resources of these narrow banks should be deployed only in Government securities.

Risks of convertibility

Those who oppose convertibility offer the following arguments against its implementations:

Credit rating institution will play a vital role in decision making by the investors. The changed view of these institutions or changes in the interest/exchange rates may have a destabilizing effect on the portfolio flows.

It exposes banks liabilities and assets to more price and exchange risks. The effect of increased volatility of exchange rate will be felt on the banks open foreign currency positions.

Banks may supplement their domestic deposit base with borrowing from off-shore markets. The volatility in interest and exchange rates can be dangerous to weak and fragile banks.

Fluctuation in interest rate may affect the cost of borrowing for emerging markets and the relative attractiveness of investing in these markets. Real exchange rate volatility may cause currency and maturity mismatches, creating large losses for bank borrowers.

Due to increased competition, the margins for the banks may be reduced.

FEMA

The Foreign Exchange Management Act (1999) or in short FEMA has been introduced as a replacement for earlier Foreign Exchange Regulation Act (FERA). FEMA became an act on the 1st day of June, 2000. FEMA was introduced because the FERA didn't fit in with post-liberalization policies. A significant change that the FEMA brought with it was that it made all offenses regarding foreign exchange civil offenses, as opposed to criminal offenses as dictated by FERA.

Check Your Progress

7 FEMA was introduced in the year_____

The main objective behind the Foreign Exchange Management Act (1999) is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments. It was also formulated to promote the orderly development and maintenance of foreign exchange market in India.

FEMA is applicable to all parts of India. The act is also applicable to all branches, offices and agencies outside India owned or controlled by a person who is a resident of India.

The FEMA head-office, also known as Enforcement Directorate is situated in New Delhi and is headed by a Director. The Directorate is further divided into 5 zonal offices in Delhi, Mumbai, Kolkata, Chennai and Jalandhar and each office is headed by a Deputy Director. Each zone is further divided into 7 sub-zonal offices headed by the Assistant Directors and 5 field units headed by Chief Enforcement Officers.

6.8 SUMMARY

India is already moving towards capital convertibility, though not at the speed envisaged by the Committee. The recent currency crisis has moderated the tone of the staunch advocates of CAC. The Reserve Bank and the Government are progressively relaxing the conditions attached to such areas as investment abroad, investment into India maintenance of foreign currency accounts by banks. Thus India is cautiously moving towards convertibility of its currency on capital account.

6.9 KEYWORDS USED IN THE LESSON

Foreign exchange control

Reserve bank of India

Exchange rate

6.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1 1973
2 Foreign Exchange Dealers Association of India
3 RBI
4 Bank Rate
5 Credit control
6 Credit Monitoring Arrangement (CMA).
7 2000.

6.11 MODEL QUESTIONS

1. Explain briefly about Authorized dealers in Foreign exchange.
2 Explain about the Anti Inflationary Monetary Policy.
3 What is Bank rate?
4 What is CRR?
5. What do you understand by Capital Account Convertibility in international exchange?

Essay questions

1. Discuss the various steps taken by the RBI in controlling Foreign exchange.
2. Explain in detail about Foreign exchange regulation act, 1973.
3. Explain the various function performed by RBI in controlling foreign exchange.

6.10 FURTHER READING

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

UNIT –VII

INTERNATIONAL FINANCIAL INSTITUTIONS

7.1 Introduction

7.2 Unit Objectives

7.3 International Monetary Fund

7.4 International Management Contract

7.5. Joint Venture

7.6. EXIM Bank

7.7 Asian Development Bank

7.8 ECGC and Export Credit Risk Insurance

7.9 The World Bank

7.10 Summary

7.11 Key words used in the lesson

7.12 Answers to check your progress questions

7.134 Model Questions

7.14 Further reading

7.1 INTRODUCTION

The main purpose of establishing International financial institution is to help member countries in stabilizing their currency. In this lesson, we can discuss the various services rendered by International financial institution.

7.2 UNIT OBJECTIVES

1. To study the various financial institution and their functions
2. To know the functions of International Monetary Fund
3. To know the operative functions of ECGC and EXIM bank
4. To find the lending procedures adopted by commercial banks

7.3 INTERNATIONAL MONETARY FUND

NOTES

The International Monetary Fund has 44 countries as its members in 1946. Currency almost all the countries (178) are members of this institutions. They only exception is Cuba. The main functions of the IMF are:

To help member countries in stabilizing their currency;

To supervise the evolution of exchange rates and provide guidance to countries on their exchange rate policies;

Provide finance to surge over balance of payment difficulties.

7.3.1 Resources of the IMF

The capital of the IMF is constituted by the totality of the subscription of members states, known as quotas. These quotas are determined as per the economic importance of each country of the IMF was SDR 144.6 billion.

Since 1970, a new instrument of reserve has been created, namely SDR (Special Drawing Right). The value of SDR represents a weighted average of 5 currencies, that is, US Dollar (40%). Deutsche Marks (21%), Japanese Yen (17%), French Franc (11%), and Pound-sterling (11%), and subsidiary of branch; this system enable a direct physical presence on the market but it involves considerable investments.

Check Your Progress

1 The capital of the IMF is constituted by the totality of the subscription of members states, known as _____.

7.3.2 Objectives

The Articles of Agreement of the IMF set out the following as the objectives of the Fund:

To promote international monetary cooperation through a permanent in situation which provides the machinery for consultation and collaboration on international monetary problems?

To facilitate the expansion and balanced growth of international trade and to contribute there by to the promotion and maintenance of high levels of employment

and real income and to the development of the productive resources off all members as primary objectives of economic policy.

To promote exchange stability, to maintain orderly exchange arrangement among members, and to avoid competitive exchange depreciation.

To assist in the establishment of a multilateral system of payments in respect of current transactions between member and in the culmination of foreign exchange restrictions which hamper the growth of world trade.

To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards thus providing them with opportunity to correct mal adjustments in their balance of payments without resorting of measure destructive to national or international prosperity.

In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in international balance of payment of members.

Thus the role of the IMF is mainly twofold; It is an organization to monitor the proper conduct of the international monetary system. Second, it is source of liquidity of liquidity for countries in need of foreign exchange to finance temporary balance of payments deficits.

Check Your Progress

2 IMF is affiliated to the _____.

7.3.3 Structure

The central office of the IMF is in Washington. The IMF is an autonomous body with 181 countries as members. It is affiliated to the UNO. The highest authority of the IMF is the Board of Governor is which each member country is represented by a governor and an alternate governor. The board of Governor is the policy making body. It meets normally every year.

The administrative responsibilities and detailed functioning of the IMF are vested with a Board of Executive Directors. At present there are 34 executive directors – 5 appointed by the USA, UK, Federal Republic of Germany, France and Japan, being the first five countries with largest quota; one appointed by Saudi Arabia, being the largest creditor country and the rest 15 elected by remaining members of

IMF. Until 1972, India was the fifth largest quota holder and was therefore entitled to appoint a director. At present there is an Indian director by virtue of election.

The Executive Director have substantial powers. Decisions regarding lending, changes in exchange rates and appointment of Managing Director are taken by the Executive Directors. Executive Directors meet frequently, even of alternate days, to decide on problems that crop up.

7.3.4 Resources

The main resource for IMF is the member's quotas. Quota represents the subscription by a member – country to the capital fund of the IMF. Quotas are fixed for each country taking into account such factors as the country's national income, reserves, export variability and the ratio of exports to national income. Apart from representing the subscription of a county to the IMF, the quota also forms the basis for determining its drawing right from the IMF, its voting power and share in allocation of SDRs. All these rights are available to a member in proportion to the quota allotted to it.

Initially, it was stipulated that 25% of a country's quota should be paid in the form of gold or US dollars and the other 75% in the country's own currency. At present, instead of contribution in gold, the 25% of the quota is to be contributed in the form of SDRs or other foreign currencies.

Since the quotas were fixed in proportion to the relative importance of each county, economically more powerful countries had the largest quotas. This was beneficial in a way because the IMF came to posses proportionately greater amounts of currencies of the larger and stronger economics. These funds are available to member – countries to draw upon when additional foreign exchange is needed to fiancé temporary balance of payments deficits. But it is also meant confining the voting right and thereby the decision making to a handful to industrially advanced countries.

Quotas are reviewed by the IMF at intervals of not more than five years. Over the years quotas have been increased. Initially the quotas totaled about $ 7 billion. After the ninth general review of quotas coming into effect from November, 1992, the

total quotas stood at about SDR 135.2 billion. With increase in membership, the detail quotas increased to SDR 145 billion by June 1995. Review of the quota may also be made with respect to the adjustment of individual member's quota in the total quotas allotted. Thus along with the increase in the quotas of individual countries, as a result of the eighth general review, selective adjustments were also made in the proportion of each member's share in the total quota.

7.3.5 General Arrangement to Borrow

IMF can supplement its resources by borrowing. A significant achievement made in this direction is the entering into General Arrangement to Borrow (GAB) in 1962. Under this agreement ten industrialized countries agreed to lend to IMF their own currencies up to the limit agreed. The ten countries, known as the Group of Ten, include Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, UK and USA; IMF can borrow under this arrangement only when the funds are needed for a participant in the arrangement. The original agreement was for a period of four years. It was subsequently renewed periodically and the latest renewal was made in 1984 in an expanded from. Switzerland also joined the arrangement with the Group of Ten. The total commitment by these countries increased to $ 17.85 billion from $ 6/72 billion previously in effect. As in the original arrangement IMF will continue to be able to call on GAB resources to fiancé drawings by participants when supplemental resources are needed to forestall or cope with an impairment of the international monetary system. But now the IMF may call upon GAB resources to finance drawings by other countries outside the Group of Ten, provided by borrowing countries have agreed to economic adjustment programme that has been approved by the international agency.

7.3.6 Drawing from IMF:

IMF provides temporary assistance to members to tide over balance of payments deficits. When the country requires foreign exchange, its own currency to the IMF and gets the required to foreign exchange. This is known as drawing from the fund. When the balance of payments position of the country improves, it should re purchase its currency from the IMF and repay the foreign exchange.

Ordinarily a member country should not borrow more then 25% of its quota in a twelve – month period. The total borrowing of a county can go up to a level where the IMF's holding of the country's currency reaches 200% of the quota. For example, if India's quota is SDR 1,000 million of which SDR 1,250 million so that the total holding of Indian rupees by the IMF does not exceed SDR 2,000 million. However, Article 5 of the articles of Agreement allows for waiver of this condition at the direction of the IMF. The Fund can waive the condition at the discretion of requirements of the number requesting the waiver. There are a number of occasions on which IMF exercised the discretion and allowed the accumulation of member's currency with it to exceed 200%.

7.3.7 Tranche Policies

The drawing of resources from the IMF by the member – countries is subject to the Fund's 'Tranche polices'. The word 'tranche' means slice in French. Under this policy, the member's right to draw from the fund is divided into five tiers or tranches. The member's right from the fund is the currency up to 100% of the country's quota is known as the 'reserve tranche' (formerly, gold tranche). Borrowing in addition to the reserve tranche is divided into four tranches, known as the 'credit tranches', each equal to 25% of the country's quota. Drawing from the reserve tranche is without any restriction. A country should first draw against the reserve tranche and subsequently the first, second, third and fourth credit tranches, in that order. The IMF may be quite liberal in the first credit tranche, but drawings from higher tranches receive greater scrutiny by IMF, the severity of scrutiny increasing with successive tranches. The borrowing country has t justify its, action by giving a programme of action in the fiscal, monetary and exchange fields. IMF may decline to allows the drawing if it is not satisfied with the plans.

Check Your Progress

3 The member's right from the fund is the currency up to 100% of the country's quota is known as the _____.

7.3.8 Compensatory Financing Facility

This facility was introduced in 1963 to provide reserves to countries that are heavily dependent on the export of primary products. Its main purpose is to need foreign exchange to a country, experiencing balance of payments deficit due to a temporary export shortfall caused by circumstances beyond the country's control. Under this scheme, funds equivalent to 100% of its quota can be drawn by a country

in addition to those available under the tranche policies. A country need not exhaust its reserve tranches before making use of the compensatory financing facility. But it must agree to cooperate with the IMF in working out appropriate solutions to its balance of payments problems.

7.3.9 Buffer Stock Financing

Buffer stock is an arrangement of holding the price line of internationally traded commodity by purchasing and selling the commodity whenever the price goes down or up. The purpose of the buffer stocks of many products when the country is experiencing balance of payments deficit. A county making use of this facility can draw up to 45% of the amount of the quota. The IMF has authorized the use of the facility in making contributions to the buffer stocks for sugar, tin and cocoa.

7.3.10 Extended Fund Facility

The extended facility is designed to provided assistance to member to meet their balance of payments deficits for longer periods and in large amounts than authorized under the tranche polices. It is especially designed to help countries suffering serious payments imbalance due to structural maladjustments in production, trade and prices. The county should be prepared to implement a comprehensive set of corrective polices covering a period of two or three years.

7.3.11 Standby Arrangements

Under standby arrangements entered into between the IMF and a member – country, the member is allowed to draw upon the resources of the IMF up to specific limits and within and agreed period. Similar to an overdraft facility being extended by a bank to its customer, the IMF extends to its member-country the facility of drawing funds as and when required. Such standby arrangements are to be negotiated between the IMF and individual members. In considering requests for standby arrangements, IMF applies the same appraisal norms as are applicable to its other facilities. The advantage under the facility is that the countries which have availed of this arrangement can know for certain and in advance that assistance would be forthcoming from the fund. They can therefore desist from imposing strict exchange and trade controls.

7.3.12 Special Oil Facility

In additional to the permanent facilities, the IMF is empowered to create temporary facilities. Accordingly, a oil facility was created in 1974 and 1975. Countries facing severe balance of payments deficits due to the unusually high oil import bills during this period were permitted to draw funds from the IMF borrowed from countries with strong balance of payments, especially the major oil exporting countries, to raise resources for this facility.

7.3.13 Enlarged access policy

The enlarged access policy of IMF, which applies to standby or extended arrangements, enables a member to draw up to 150% of its quota annually or up to 450% or its quota in a period of three years. The current limits are 90% of quota annually, 270% of quota over three years and cumulative limit of 400% of quota. For members undertaking exceptional adjustment programmes the limits the 110%, 300% and 440% of quota respectively.

7.3.14 Structural Adjustment Facility (SAF)

The SAF was established in March 1986 to provide financial assistance on confessional terms in support of the balance of payments adjustment efforts of low-income countries. The loans are provide to countries facing protracted balance of payments problems in support of their medium-term programmes of macro-economic and structural adjustment aimed at fostering growth and strengthening the balance of payments position. Loans are made in proportion to a member's quota in the Fund. They are disbursed over a period of 3 years with maximum three-year access to 63.5% of the quota; they carry interest at +% p.a. and have a repayment period of 5 to 10 years.

The borrowing country is expected to draw a comprehensive three-year policy framework paper, with the joint assistance of the staff of the World Bank and IMF, setting out the macro-economic and structural policy objectives for the ensuring three-year period, the strategy and measures to be employed and estimates of financial requirements for the adjustment programe.

7.3.15 Enhanced structural adjustment facility (ESAF)

On December 187, the IMF established this new facility from which its poorest member-countries can draw when undertaking strong three-year macro-economic and structural programmes. This facility is similar to SAF with regard to interest and repayment and is in addition to the SAF scheme.

7.3.16 Exchange Rate Arrangement

The most important feature of IMF system, as originally conceived, was the exchanged rate arrangements of its member-countries. The original plan of IMF tired to incorporate the features of the gold exchange standard. The basis structure of exchange rates was that of fixed exchange rates, with flexibility built into it to a certain extent.

Under gold exchange standard, one or two major countries remain on gold standard and their currencies are convertible into gold. Other countries make their currencies convertible into the currency which remains on gold standard. The same arrangement was retained in the IMF plan, with dollar taking the place of the convertible currency.

Master franchise.

In this system, the master-franchisee acquires the right to choose his own franchisees in a particular country, to sell franchise and receive the rent, that is, to develop his own franchisee network, in return, he pays an initial rent as well as a predetermined part of the rent that he would receive. These contracts contain clauses relating to profit as well as repurchase. This system eliminates the risk for the franchisor and spares him the cost of setting up units in foreign countries. Generally, the franchisee has a great deal of freedom.

Some of the important domains in which franchising is done are:

Retailing (Beneton,);

Fast food (McDonalds, Pizza Hut, etc.);

Hotels (Holiday Inn, Hilton, Novotel,);

Services (Hertz, Manpower,);

Industry (General Motors, Yo plait, L'Oreal,).

An essential difference between license and franchise agreements lies in the nature of their basic activity. A license holder manufactures a product from a patent while a franchise holder distributes goods and services.

Success of a franchise abroad depends on several factors

Quality of the product or the service rendered;

Knowledge of foreign markets;

Socio-economic factors of the country'

Motivation of the franchise holder;

Rigorous and regular follow-up by the franchisor.

7.4 INTERNATIONAL MANAGEMENTS CONTRACTS

By a management contract, a firm helps another firm to accomplish general or specialized management tasks during a certain periods in consideration of payment. These contracts are often demanded by the government of a country that has expropriated and enterprise but want to maintain technical service. This was the case of petroleum companies when they were nationalized in the countries where they had subsidiaries or agencies.

Such contracts may facilitate and company furnishing technical assistance and access to some raw materials.

7.4.1 Turnkey Projects

A turnkey projects contract stipulates setting upon construction of a factory which will transfer to its owner as soon as it starts functioning effectively. For example, two French companies in collaboration with and Indonesian enterprise completed the airport of Jakarta as a turkey project in 1984.

Payment for the operations is spread over a period of time, and is linked to the progress of the works.

7.4.2 Specific Contracts

Some companies, in view of their technical competence are invited to operate in foreign countries. The domains can be as varied as hydrocarbon exploration, public works, construction of roads, etc.

Contracts for technological cooperation and mutual benefit may be signed for a specified period between two or several companies for exchange of information in their respective research activities. For example, Photo watt, a subsidiary of Elf Aquitaine of France and Fuji Electric of Japan signed a contract to develop solar cells. Similarly, agreements were signed between Elf Aquitaine and Pechiney (both of France) and Today of Japan for the production of carbon fiber, to be sold on West European market.

7.5 JOINT VENTURE

Check Your Progress

4 A joint venture is a collaboration of _____ more enterprises (legal or physical entities) to achieve a common goal.

A joint venture is a collaboration of two more enterprises (legal or physical entities) to achieve a common goal (say profit sharing in business or services). In international context, one of the parties is generally from the host country. The parties agree to contribute the capital and share profits as per pre-decided ration.

A joint venture has certain number of advantages as well of disadvantages.

Advantages of Joint Ventures

Joint venture constitutes a relative protection against political risk or expropriation.

It may bring about synergy between the two firms if they combine their respective strong points in different domains. For example, a foreign firm may offer a good distribution network and thus stimulate the sales.

It may open new financial market and permit new means of financing;

It may permit certain tax advantages.

Disadvantages of joint Ventures

Different Management styles may often create problems.

Even if the company holds mere then 50 per cent shares, it may be obstructed in the performance of its management of minority shareholders.

If the company holds less than 50 per cent shares it may be obstructed in the performance of its management tasks.

Certain commitments, given in the beginning, may turn out to be difficult to fulfill after sometime, say, debt servicing obligation, or export obligation as a percentage of production.

Despite these limitations, joint ventures are widespread in industrial as well as developing countries.

7.5.1 Mergers and Acquisitions

The growth process in international business can be facilitated by acquisitions of existing businesses and or merging with them.

7.5.2 Export Finance

The international market is generally very competitive and sensitive and the credit facilities made available to the buyers are on of the important determinants of export business.

The extent to which credit must be extended to the importer depends on the sale terms. If the exporter gets cash in advance, there will not be any problem in respect of finance; but this is not common. Even if the exporter gets the payment at the time of the shipment of the goods, he has to make his own arrangement to meet his financial needs at the pre-shipment stage. If the sale is on credit, as it usually is, the exporter will be still more constrained financially. It is, therefore, necessary to make institutional credit available to the export sector to meet its pre-shipment financial requirements; for such credit facilities will enable the exporter not only to meet their financial requirements at the pre-shipment stage but also to extent reasonable credit facilities to foreign buyers.

Sometimes, institutional credit is extended to foreign buyers instead of to exporters. The buyer's credit is extended, usually, to the buyer of capital goods.

7.6 EXIM BANK

The Export-import Bank of India, set-up in 1982, for the purpose of financing, facilitation and promoting foreign trade of India, is the principal financial institution in the country for coordinating working of institutions engaged financing exports and imports.

The Exim Bank is fully owned by the Government of India and is managed by a Board of Directors with representation from Government, financial institutions, banks and business community. The operations are grouped into Project Finance, Trade finance and overseas Investment Finance, supported by planning and coordination Groups.

7.6.1 Objectives and Functions

The objectives and functions of the EXIM Bank include the following:

Grant of loans and advances in India solely or jointly with commercial banks to persons exporting or intending to export from India goods which may include the export of turnkey projects and civil consultancy services.

Grant of lines of credit of Government, financial institutions and other suitable organizations in foreign countries to enable person outside India to import other services, including consultancy services.

Handling transactions where a mix of government credit and commercial credit for exports is involved.

Purchasing, discounting and negotiating export bills.

Selling or discounting and negotiating export bills.

Discounting of export bills negotiated or purchased by a scheduled bank or financial institution notified by government, or granting loans and advances against such bills.

Providing refinance facilities to specified financial institutions against credits extended by them for specified exports or imports.

Granting loans and advances or issuing guarantees solely or jointly with a commercial bank for the import of goods and services from abroad.

Issuing confirmation/endorsing letters of credit on behalf of exporters in India, negotiating, collecting bills under letters of credit, opening letters of credit on behalf of importers of goods or services and negotiating documents received there under.

Buying and selling foreign exchange and performing such other functions of an authorized dealer as may be necessary for the discharge of the functions of an export-import bank.

Undertaking and financing research, surveys and techno-economic studies bearing on the promotion and development of international trade.

Providing technical, administrative and financial assistance to any exporter in India or any other person who intends to export goods from India for the promotion, management or expansion of any industry with a view to developing international trade.

The EXIM Bank extends both funded and non-funded assistance for promotion of foreign trade.

The funded assistance programme of the Bank includes direct financial assistance to exporters, rediscounting of export bills, technology and consultancy services financing, refinancing of export credit and re-lending facility to banks abroad.

The non-funded assistance is in the from of guarantees which are in the form of bid bonds, advance payment and performance guarantees, retention money guarantees and guarantees for raising finance abroad.

The Exim Bank participates with commercial banks in India in the issuance of guarantees in foreign currencies on behalf of Indian exporter/contractors in favour of overseas importers/employers and bank.

In 1983, a scheme known as the Exim Syndication Facility was introduced to attract greater participation in export credit by commercial banks in India who are authorized dealers in foreign exchange. Under this scheme, the Exim Bank provides funds for an export proposal and syndicates the credit risks to commercial banks, and the banks for assuming the risks earn a commission of 0.5 per cent annum from the Exim Bank.

The Exim Bank also provides information and advisory services to enable exporters to evaluate the international risks, export opportunities and competitiveness. These include country studies. Merchant banking services, advice on international marketing and data to enable effective participations in opportunities offered by multilateral institutions.

Further, the Bank carries out Research and Analysis on specific industry sub-sectors with export potential and international trade related subjects. These are widely disseminated amongst exporters, academicians, industry and trade organization and government.

Thus, the Exim Bank follows three prolonged strategy to promote Indian exports. More than export finance, the Bank is engaged in export capability creation.

7.6.2 Lending Programmes:

The Exim Bank promotes export through a variety and range of lending programs. These programmes are tailored to meet the needs of different customer groups, viz., Indian exporters, overseas entities and commercial banks.

Programme	Use
For Indian Exporters	
Export (Supplier's) Credit	Enables Indian exporters to extend term Credit to importer overseas, of Eligible Indian goods.
Finance for Consultancy and Technology Services	Enables Indian exporters of consultancy and technology services to extend term Credit to importers overseas.
Pre-Shipment Credit	Enables Indian exporter to buy raw

	material and other inputs for export contracts involving cycle time exceeding six months
Foreign currency Pre-Shipment Credit	Enables eligible exporters to access finance through commercial banks for import of raw materials and other inputs need for export production.
Finance for EOUs & Units EPZs	Enables Indian companies to acquire Indigenous and imported machinery and other assets for export production.
Foreign Currency Lines of Credit for imports	Enable eligible export-oriented units to acquire imported machinery for Export production.
Production Equipment finance	Enable eligible export-oriented units to acquire equipment.
Export Marketing Finance	Enables exporters to implements market Development programmes and finances Productive capabilities through loan Financing.
Export product Development	Enables Indian firms to undertake Product development, R&D for exports.
Overseas Investment Finance	Enables Indian promoters to finance equity contribution in joint ventures set up Abroad.
Project Preparatory Services Overseas	Enables Indian Consultancy firms to undertake project preparatory studies In developing countries by grant/loan financing
Business Advisory & Technical	Enables Indian Consultancy firms to undertake specific assignments in select countries through grant financing.
Africa Project Development Facility	Enables India consultancy firm undertake specific assignments in sub-

	Saharan Africa through grant financing.
EC International Investment Partners Facility	Enables setting up of joint ventures in India companies and enterprises in the European Community.
For Commercial Banks	
Refinance of Export (supplier's) Credit	Enables banks to offer credit to India exporters of eligible goods, who extend term credit over 180 days to Importers overseas.
Relenting Facility	Enables banks overseas to make available term finance to their clients, for import of eligible Indian goods.
Refinance of Term Loans to EOUs	Enables banks to offer credit to eligible export oriented units to acquire indigenous and imported machinery and other assets for export production.
Refinance of Term Loans for Computer Software Exports	Enables acquisition of imported and indigenous computer systems, and project related assets.
Small Scale Industry (SSI) Export Bills Rediscounting	Enables banks to rediscount export, bills of their SSI customers with usance not exceeding 90 days
Bulk import Finance	Enables banks to offer finance to importer for bulk import of consumable.
For Overseas Entities	
Line of Credit	Enables overseas financial institutions, foreign government, their agencies to extent term loans to finance import of eligible goods form India.
Buyer's Credit	Enables overseas buyers to import eligible goods from India on deferred credit terms.

To the Indian exporter, the Bank offers finance at various stages of the export cycle, viz., export product development, export production, export marketing and export credit at pre and post-shipment stages. The table gives a summary view of the lending programmes of the Exim Bank.

Even before the Second World War ended, Allied countries began to devote serious thought and efforts in developing a system that would end the chaotic conditions prevailing and pave the way for an orderly conduct of international trade and promote good monetary relations among the countries. They worked with the objectives of finding a system which would (a) help remove the restrictions on trade, (b) ensure free convertibility of currencies (which was suspended during the inter war period due to multitude of exchange controls) and maintain stability in exchange rates among the currencies in the these efforts the USA (represented by Mr. H.D White) and the UK (represented by Lord Keynes) had a greater role to play.

In June 1944, representative of 44 Allied powers met at Brettonwoods, New Hampshire, USA, to give concrete shape to their ideas. The agreement reached at this meeting provided for establishing two institutions which came to be known as the 'Brettonwoods twins'. The institutions set up were the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank).

7.7 ASIAN DEVELOPMENT BANK

Asian Development Bank (ADB) is development bank started in 1966 under the aegis of ECAFE (United Nations Economic Commission for Asia and Far East). Its membership consists of countries from Asian region as well as from other region. There are 47 members of which 32 countries are from Asia-Pacific region and !5 countries are from Europe and North America.

Check Your Progress

5 Asian Development Bank (ADB) is development bank started in the year____

7.7.1 Function

The main purposes and function of ADB are to:

Promote investment in the ECAFE region of public and private capital for development purpose;

Utilize the available resources for financing development, giving priority to those regional and sub-regional as well as national projects and programmes which will contribute most effectively to the harmonious economic growth of the region as a whole, and having special regard to the needs of the smaller or less developed member-countries in the region; meet request from members in the region to assist them in coordination of their development policies and plans with a view o achieving better utilizations of their resources making their economies more complementary, and promoting the orderly expansion of their foreign trade, in particular, intra regional trade;

Provide technical assistance for preparation, financing and execution of development projects and programmes. Including the formulation of specific proposals; to co-operate with the United Nations and its organs and subsidiary bodies, including, in particular, ECAFE and with public international organizations and other international institutions, as well as entities whether public or private, and to interest such institutions and entities in new opportunities for investment and assistance; and undertake such other activities and to provide such other services as may advance its purpose.

ADB finances principally specific projects in the region. It also provides programme, sector and multi-project loans. It may make loans to or invest in the project concerned. It may also guarantee loans granted to the projects. Most ot the loans granted are hard loans or tied loans. However, loans from special funds set aside by the ADB up to 10% of its paid-up-capital are granted under soft loan terms. Soft loans are normally granted to projects of high development priority and requiring longer periods of repayment with lower rates of interest. ADB normally finances foreign exchange cost of the project and the loan is repayable currency in which it is made.

7.7.2 Organization

The Bank's highest policy-making body is the Board of Governors which meets annually. The direction of the Bank's general operation is the responsibility of the Board of Directors composed of 12 director's **eight** representing regional

countries and four representing non-Regina countries. The President of the Bank, elected by the Board of Governors, is also the Chairman of the Board of Directors.

7.7.3 Resources

The financial resources of ADB consist of ordinary capital resources, comprising subscribed capital, reserves and funds raised through borrowings; and Special Funds, comprising contributions made by member-countries and amounts previously set aside from the paid-up capital. Loans from ordinary capital resources, which account for almost 69 per cent or Bank lending, are generally made to member-countries which have attained a some what higher level of economic development. Loans from Special Funds, which are administered countries on highly confessional terms.

7.7.4 Evaluation

ADB has become a major catalyst in promoting the development of the most populous and fastest growing region in the world today. With the growing need for larger and more diversified inflows of capital of the region, the Bank expanding its co-financing activities, with official as well as commercial and export credit sources. The Bank has also entered in equity investment operations. India is the second largest subscriber, after Japan, among the regional members and third largest among all members, after Japan and USA. But it has started to avail loan from the Bank only recently.

7.8 ECGC AND EXPORT CREDIT RISK INSURANCE

The Export Credit Guarantee Corporation of India Ltd., a company wholly owned by Government of India and which function under the administrative control of the Ministry of Commerce, has a number of schemes to cover several risks which are not covered by the general insurers.

The primary role of ECGC is to support and strengthen the export promotion derived in Indian by:

providing a range of credit risk insurance covers to exporter against loss in export of goods and service, and

offering guarantees to banks and fanatical institution to enable exporters to obtain better facilities from them.

In other words, the objectives of ECGC are:

To provide insurance cover to exporters against political risks and commercial risks;

To provide insurance cover to exporters against the risk of exchange rate fluctuations in respects deferred payment.

To provide cover to banks against export credit and guarantees extended by them.

To provide insurance cover to Indian investors abroad against political risks.

7.8.1 Insurance Covers

The covers issued by ECGC may be broadly divided into the following four groups:

Standard policies issued exporters to protect them against payment risks involved in exports on short-term credit.

Specific policies designed to protect India firms against payment risks involved in exports on deferred terms of payment, services rendered to foreign parties, and construction works and turnkey projects undertaken abroad.

Financial guarantees issued to banks in India protect them from risks of loss involved in their extending financial support to exporters at the pre-shipment as well as post-shipment stages.

7.8.2 Special Schemes:

Standard Policies

ECGC has designed four types of Standard Policies it provide cover for shipments made on short-term credits.

Shipment (Comprehensive Risks) Policy which covers both commercial and political risks from the date of shipment.

Shipment (Political Risks) Policy which covers only political risks from the date of contract.

Contracts (Comprehensive Risks) Policy which covers both commercial and political risks from the date of contract

Contracts (Political Risks) Policy which covers both only political risk from the date of contract.

Risks Covered by Standard Policies

The risks covered under the standard policies are:

7.8.3 Commercial Risks

Insolvency of the buyer:

Buyer's protracted default to pay for goods accepted by him: and

Buyer's failure for accept goods subject to certain conditions.

7.8.4 Political Risks

Imposition of restrictions of remittances by the government in the buyer's country or any government action which may block or delay payment to the exporter;

War, revolution or civil disturbances in the buyer's country.

New import licensing restrictions or cancellation of a valid import license in the buyer's country, after the date of shipment or contract as applicable;

Cancellation of export license or imposition of new export licensing restrictions in India after effective date of contract (under contracts policy);

Payment of additional handling, transport or insurance charges occasioned by interruption or diversion of voyage which cannot be recovered from the buyer; and

Any other cause of loss occurring outside India, not normally insured by general insurers, and beyond the control of the exporter and/or the buyer.

7.8.5 Risks not covered

The standard Policies do not cover losses due to the following risks:

Commercial disputes including quality disputes raised by the buyer, unless the exporter obtains a decree from the competent count of law in the buyer's county in his favor;

Causes inherit in the nature of goods;

Buyer's failure to obtain necessary import or exchange authorization from the authorities in his county;

Insolvency or default of any agent of the exporter or of the collecting bank;

Loss of damage to goods which can be covered by general issuers;

Exchange rate fluctuation; and

Failure of the exporter to fulfill the terms of the export contract or negligence on his part.

7.8.6 Extent of Cover

It is customary in credit insurance to make the insured share a small percentage of the risk. ECGC normally pays 90 per cent of the losses on account of political or commercial risk. In the event of loss due repudiation of contractual obligation by the buyers, ECGC indemnifies the exporter up to 90 per cent of the loss if final and enforceable decrees against the overseas buyer is obtained in a competent court of low in the buyer's country. The corporation, at its discretion, may waive such legal action where it is satisfied that such legal action is not worthwhile and in that even also losses are indemnified up to 90 per cent. Recoveries mad after the payment of claim are shared with the ECGC in the same proportion in which the loss was borne.

Whole Turnover Principle

ECGC expects a fair spread of risks insured. Therefore, and exporter is required to insure all the shipment that may be made by him during the next 2 years, except those made against advance payment or irrevocable Letters of credit confirmed by banks in India. Exclusions are, however, possible where items are no of an allied nature.

NOTES

7.8.7 Consignment Exports

Exports on Consignment basis may be covered under Shipment (Comprehensive Risks) Policy by a suitable endorsement thereon. While political risks are covered from the date of shipment till the date of receipt of payment in India, commercial risks are covered only after the Agent/Stockholder submits the Account Sales to the exporter. The risk of the Agent/stockholder not returning the unsold goods is not covered under the policy.

7.8.8 Specific Policies

The standard Policy is a whole turnover policy designed to provide a continuing insurance for the regular flow of an exporter's shipment of raw materials, consumer goods and consumer durables for which credit period does not exceed 180 days. Contracts for export of capital goods or turnkey projects of construction works or rendering services abroad are not of a repetitive nature. Such transactions are, therefore, insured by ECGC on a case-to-case basis under specific policies.

All contracts for export on deferred payment terms and contracts for turnkey projects and construction works abroad require prior clearance of Authorized Dealers, Exim Bank or the Working Group in terms of power delegated to them as per exchange control regulations. Applications for this purpose are to be submitted to the Authorize Dealer (the financing bank) which will forward applications beyond its delegated power to the Exim Bank.

7.8.8.1. Specific Policy for Supply Contracts

Specific Policy for supply contracts may take any of the following four forms:

Specific Shipments (Comprehensive Risks) Policy to cover both commercial and political risks at the post-shipment stage;

Specific shipments (Political Risks) Policy to cover only political risks at the post-shipment stage in cases where the buyer is an overseas Government or payments are guaranteed by a government or by banks, or are made to associates;

Specific Contract (Comprehensive Risks) Policy; and

Specific Policy provides cover from the date of contract; Losses that may be sustained by an exporter at the pre-shipment stage due to frustration of contract are covered under this policy in addition to the cover provided by the Shipments Policy.

7.8.8.2. Insurance Cover for the Buyer's Credit and Line of Credit

Financial institutions in India, like those in several other countries, have started direct tending to buyers or financial institutions in developing countries for importing machinery and equipment from India. This kind of financing facilitates immediate payment to exporter and frees them from the problem of credit management as well as from the fear of loss on account of overseas credit risks.

Financing may take the buyer's Credit or Line of Credit. Buyer's Credit is a loan extended by a financial institution, or a consortium of financial institutions to the buyer for financing a particular export contract. Under Line of Credit, a loan is extended to government or financial institutions in the importing country for financing import of specified items from lending country.

ECGC has evolved schemes to protect financial institutions in India which extend these types of credit for financing export from India. Insurance agreement will be drawn up on case-to-case basis, having regard to the terms of the credit.

7.8.8.3. Services Policy

Where Indian firms render services to foreign parties, they would be exposed to payment risks similar to those involved in export of goods. Services Policy offer

protection to Indian firms against such payment risks. The policy has been designed broadly on the lines of ECGC's insurance policies covering export of goods.

A wide range of services like technical or professional services, hiring or leasing can be covered under the policies.

The Comprehensive Risks Policy covers the following risks:

Insolvency of the buyers,

Protracted default in payment

Restriction on remittances in the buyer's country or any Government action which may block or delay payment to the exporter,

War between India and the buyer's country,

Revolution or other civil disturbances in the buyer's country,

Government action in India or in buyer's country which prevent the performance of the contract, and

Any other cause of loss occurred outside India and beyond the control of the buyer or the seller.

7.9 THE WORLD BANK

The International Bank for Reconstruction and development (IBRD) or the World Bank was established in 195 under the Bretton Woods agreement of 1944 to assist in bringing about a smooth transition from wartime to peacetime economy. It is a sister institution of the International Monetary Fund.

7.9.1 Functions

The IBRD, also called the Bank, performs the following functions:

1. To assist in the reconstructions and development of territories of its members by facilitating the investment of capital for productive purpose, and the

encouragement of the development of productive facilities and resources in less developed countries.

2. To promote private foreign investment by means of guarantees of participation in loans and other investment made by private investor, and when capital is not available on reasonable terms, to supplement private investment by providing finance for productive purpose out of its own resources or from borrowed funds.

3. to promote the long-range balanced growth of international trade and the maintenance of equilibrium in the balance of payments of member countries by encouraging international investment for the development of their productive resource, thereby assisting in raising productivity, the standard of living and conditions of workers in their territories.

4. To arrange the loans made or guaranteed by it in relations to international loans through other channels so that more useful and urgent small and large projects are dealt with first.

7.9.2 Membership

The members of the international Monetary Fund are the members of the IBRD. It had 151 members as on April 1988. If the Bank incurs a financial loss in the year in which a member resigns, it is required to pay its share of the loss on demand.

7.9.3 Organization

Like IMF, the IBRD has a three-tier structure with a President, Executive Directors and Board of Governors. On 1 July 1986, Barber Conable became the seventh President of the World Bank Group (IBFD, IDA and IFC). He was elected by the Bank's Executive Directors whose number is twenty-one. Of these, 5 are appointed by the five largest shareholders of the World Bank. They are the US, UK< West Germany, France and Japan. The remaining 16 are elected by the Board of Governors. There are also Alternate Directors. The first five belong to the same permanent member countries to which the Executive Directors belong. But the

remaining Alternate Directors elected from among the group of countries who cast their votes to choose the 16 Executive Directors belonging to their regions. The President of the World Bank presides over the meetings of the Board of Executive Directors regularly once a month. The Executive Directors decide about policy within the framework of the Articles of Agreement. They consider and decide on the loan and credit proposals made by the president. They also present to the Board of Governors as its annual meetings audited accounts, and administrative budget, and the Annual Report on the operations and policies of the Bank. The President has a staff of more than 6000 persons who carry on the working of the World Bank. He is assisted by a number of Senior Vice-Presidents and Directors of various departments and regions. The Board of Governors is the supreme body. Every member country appoints one Governor and an Alternate Governor for a period of five years. The voting power of each Governor is related to the financial contribution of its government.

7.9.4 Capital Structure

The IBRD started with an authorized capital of $ 10 billion divided into 1,00,000 shares of $ 1,00,000. Of this, $ 9,400 million was actually subscribed. On 30 June 1985 the authorized capital stock of the IBRD comprised 7,16,500 authorized shares of the par value of SRD 1,00,000 each. Of these, 58,154 shares had been subscribed. Thus its subscribed capital is SRD 51,315,400 each. Ten per cent of subscribed capital has been called and paid in. The remaining 90 per cent is subject to call only when required to meet its obligations created by borrowing or guaranteeing loans.

7.9.5 Funding Strategy

The IBRD's funding strategy has the following four basic objectives: The first it to ensure the availability of funds to the Bank. For this purpose, the IBRD seeks to maintain unutilized access to funds in the markets in which it borrows. The second objective is to minimize the effective cost of those funds to its borrowers. This is done through the currency mix of its borrowings and the time of borrowings. In the former case, it tends to maximize borrowings in currencies with low nominal interest rates. The time of borrowings is manipulated in two ways: (a) when interest rates are

expected to rise, the Bank seeks to increase its borrowings, and (b) when interest rates are expected to fall, it seeks to differ borrowings. The third objective is to control volatility in net income and overall loan charges. For this purpose, the Bank started in July 1982 a pool-based variable lending rate system that uniformly adjusts interest charges applicable to the outstanding balance on all loans made under it. The existing loans were not affected by this lending system. When the majority of loans and borrowings are incorporated into the new lending rat system in future, the volatility of interest rates will be much reduced. The four the objective of the funding strategy is to provide an appropriate degree of maturity transformation between its borrowing and lending. Maturity transformation refers to the Banks capacity to lend at longer maturities then than it borrows. At the same time, it provides its borrower with a modest degree of maturity transformation.

7.9.6 Borrowing and Lending Activities

The IBRD is a corporate institution whose capital is subscribed by its members. It finances its lending operations primarily from its own medium and long-term borrowings in the international capital markets, and currency swap agreements (CSA). Under the CSA proceeds of a borrowing country are converted into a different currency, and simultaneously, a forward exchange agreement is executed providing for a schedule of future exchanges of the two currencies on order to recover the currency converted. The effect of currency swaps is to transform the cost of original borrowing to a cost which reflects the market yield of the currency obtained in the conversion. For instance, the average cost of IBRD borrowing outstanding during the fiscal year 1984 was 8.70 per cent.

The Bank also borrowers under the Discount-Note Programme. First, it places bonds and notes directly with its member governments, government agencies, and central banks. Second, it offers issues to invertors and in the public markets through investing banking firms, merchant banks, and commercial banks.

The IBRD has evolved two new borrowing instruments. First, Central Bank Facility (CBI) is a one-year, US dollar dominated facility for borrowing from official sources, particularly central Banks. It is designed to reverse the declining trend it the IBRD's borrowings from such sources since the 1980s. in 1984, the Executive

Directors authorized the Bank to borrow under the Facility up to $750 million with a one year maturity plus funds maturity within a month under the Facility. Second, borrowings in Floating-Rate Notes (FRNs) is meant to help the IBRD to meet some of its funding strategy. The FRN market enables the Bank to gain access to a set of investors like commercial banks and certain other financial institutions which have not traditionally bought IBRD notes. The FRNs carry a medium/long-term maturity. In 1984 the Executive Directors authorized the IBRD to borrow up to an aggregate amount of $ 400 million.

The total borrowings of all types by the Bank in the fiscal year 1984 amounted to $ 9.8 billion. A substantial amount of its resources also comes from its retained earnings and the flow of payments on its loans.

The Bank lends to member countries in any of the following ways: (i) by marketing or participating in loans out of its own funds; (ii) by making or participating in direct loans out of funds raised in the market of a member or otherwise borrowed by the Bank; (iii) by guaranteeing in whole or in part loans made by private investors through the usual investment channels.

The total amount outstanding of participating in loans, direct loans and guarantees should not exceed 100 per cent of its unimpaired subscribed capital, reserves and surplus. It guarantees, participates in or makes loans to its members on the following conditions.

(i) If its is satisfied that in the prevailing market conditions the borrower would be unable to obtain the loan under conditions which in the opinion of the Bank are reasonable to the borrower;

(ii) Loans are for specific projects of reconstruction or development, except in special circumstances.

(iii) If the member in whose territory the project is located is not itself the borrower, the member or its central bank fully guarantees the repayment of the principal, the payment of interest and other charges on the loan.

(iv) The project for which the loan is required has been recommended by a competent committee in form of a written report after a careful study of the proposal.

(v) The borrower or the guarantor is in a position to meet its obligations under the load.

7.9.7 Structural Adjustment Facility (SAF)

Since 1985, the IBRD has introduced SAF to borrowing countries in order to reduce their balance of payments deficits while maintaining or regaining their economic growth. SAF funds are used as luxury and military imports. SAF's are released in two parts and are based on stiffer conditions laid down by the Bank. The Bank aims at providing support to programmes running from 5 to 7 years through a series of up to five SAF's to a borrowing country.

Up to July 1987, 16 countries had been sanctioned SDR 813 million, end of which SDR 256 million had been disbursed under this facility.

7.9.8 Enhanced Structural Adjustment Facility (ESAF)

In December 1987, the Bank has set up the ESAF to increase the availability of concessional resources to low-income member countries. It will provide new concessional resources totaling SDR 6 billon which will be financed by special loans and contributions from developed and OPEC countries. Like the SAF, ESAF is meant to help the borrowing countries reduce their balance of payments deficits and encourage growth. Its financial terms are similar to the SAF. The interest rate will be 0.5 per cent with repayments in ten semi annual interest rate will be 0.5 per cent with repayments in ten semiannual installments beginning after 5 1/2 years of disbursements.

The Bank makes medium and long-term loans usually running up to the completion of the project. Loans generally have a grace period of 5 years and repayable over 20 years or less. The interest rate charged on loans by the Bank is calculated with guideline related to its cost of borrowing. So loans are at variable interest rates. It changes an annual commitment charge of 0.75 per cent on

undistributed balances and a one-time front-end fee on the amount of loan. The total IBRD lending during fiscal year 1985 amounted to $ 11.4 billion.

The Bank's lending operation for two decades since its inception were concentrated heavily upon capital infrastructural projects such as power generation and distribution, railways and roads, ports telecommunications, major irrigation works, etc. Since the 1970s, loans for infrastructural investments have come down. Instead, it has begun to finance changes in the educational system in the developing countries, to 'establish institutions for the financing of industrial investments and provision of technical assistance in the selection and appraisal of industrial projects, and to help in the preparation of agricultural projects. Its present development strategy lays more emphasis on investments that can directly affect the welfare of the poor people of the developing countries by for agriculture and rural development, education, family planning, nutrition, low-cost housing, drinking water and sewerage. The distribution of IBRD funds is made by the country-income group and by sector to the developing countries.

7.9.9 Special Action Programme

The Special Action Programme (SAP) has been started in 1983 to strengthen the IBRD's ability to assist member countries in adjusting to the current economic environment. It has four major elements: (1) An expansion in lending for high-priority operations that support structural adjustment, policy changes, production for export, fuller use of existing capacity, and the maintenance of crucial infrastructure, (2) Accelerated disbursements under existing and new investment commitment to ensure timely implementation of high-priority projects, (3) Expanded advisory services on the design and implementation of appropriate policies. There include reviews of state enterprises studies to strengthen development-orientation and project-implementation capabilities, studies to increase the mobilization of domestic resources, reviews of incentive for export diversification, and exploration of way to strengthen debt-management capabilities, (4) Enlisting familiar efforts by other donors for fast-disbursing assistance in support of programmes of the Bank and IMF.

7.9.10 Other Activities

The other activities of the IBRD include training, technical assistance, inter-organizational cooperation, economic research and studies, operation evaluation, and settlement of investment disputes of its members.

The Bank set up a staff college in 1956, known as the Economic Development Institute (EDI) for training senior officials of the member developing countries. It help them to improve the management of their economies and to increase the efficiency of their investment programmes. Its training material ranges from macroeconomic planning, pricing and development policies to management of agricultural research, rural health care, industrial policy, energy policy, railway management, etc. the EDI also organize seminars in Washington and in different regions the world in cooperation with regional institutes.

Technical assistance has been an integral part of the Bank operation since its inception. It consists of two bread categories: (i) engineering –related, such as feasibility studies, engineering design, and construction, supervision; and (ii) institution-related, such as diagnostic policy and institutional studies, management support and training. The primary way of providing technical assistance is through loans made for specific sectors and in components of loans made for capital infrastructures. Such technical assistance includes fund for supervision, implementation, and engineering services, energy, power, transportation, water supply, industry, etc. To meet gaps in project preparation and for institution building, the Bank advances funds to prospective buyers through Project Preparation Facility (PPF) created in 1975. The Bank also serves as executing agency for projects financed by the United Nation Development Programme (UNDP). Further it provides such technical assistance as short-term training, secondment of adviser's transfer of technology service on evaluation and monitoring panels, and demographic, financial and economic advice on project preparation.

The IBRD is also engaged in inter-organizational cooperation. Cooperation between the IBRD and other international organizations is based on formal agreements such the Cooperative Programmes between it and FAO, the UNESCO, the WHO, the GATT, the UNCTAD, the United nations Environment Programme

(UNEP), the UNDP, the United Nations Industrial Development Organization (UNIDO), the International Fund for Agricultural Development (IFAD), the ILO, the African Development Bank, the Asian Development Bank, etc.

The Bank devotes roughly 3 per cent of its administrative budget to economic and social research. The research programme was started in 1971. Since then 165 research projects have been completed, while180 are in progress. In addition, there are more than 100 generally smaller research studies undertaken at the discretion of the Bank departments. In 1983, the Bank established a Research policy council (RPC) to provide leadership in the guidance, coordination, and evaluation of all Bank research. Bank's Research Advisory group has also been set up to advice the RPC. A small and more technically oriented Research Projects Approval Committee has been created. Research activities are undertaken by the Bank's own research staff and also in collaboration with outside researchers. The results of completed research projects appear in articles in international economic journals, books, in World Band Staff Working Papers, and its own journal, Finance and Development. Research projects in progress are described in and annual publication, World Bank Research Programme: Abstracts of Current Studies. The Bank also helps strengthen indigenous research capacity in member developing countries.

The Bank helps borrowers in the post-evaluation of their Bank assisted projects. It has set up the Operations Evaluation Department (OED) for this purpose. Project reviewed are also subject to performance audit by the OED staff, Members of borrower's staff visit his Department for seeding help in the preparation of project completion report. The EDI also includes a course devoted to monitoring and evaluation by borrowers which is conducted by it in collaboration with EDI Staff.

The Bank has set up the International Centre of Settlement of Investment Disputes (ICSID) between States and National of other Stated. All members of the Bank have signed and deposited their instruments of ratification pertaining to this. The bank has successfully medicated in solving many international disputes such as the River Water Dispute between India and Pakistan, and of the Suez Canal between Egypt and the UK.

7.9.11 Critical Appraisal

The IBRD has been quite successful in achieving its principal objective of reconstruction and development. It helped in the reconstruction of Europe after its destruction in the Second World War. It has also been helping the developed and developing countries alike in the process of growth. Since the 1970s, it has been lending more to developing countries not only for infrastructural investment but also for raising the productivity and standard of living of the poor people. Of the total IBRD loans in the fiscal years 1984, member countries in Latin America and Caribbean received 31 per cent, in East Asia and Pacific 24.5 per cent, and in South Asia 8.6 per cent. On a sect oral basis, agriculture and rural development received 21 per cent, energy 22 per cent, transportation 18 per cent, water supply and sewerage 5 per cent, and education 4 per cent. Still critics are not lacking in pointing out certain criticisms of its lending policies, some of them are discussed as under.

1. It is argued that the Bank charges a very high rate of interest on loans, as also and annual commitment charge on undistributed balances and a front-end fee. Recently the Bank has adopted a new procedure relate to the cost of borrowing for calculating the interest rate and front-end fee. So they are no longer fixed arbitrarily at a high level. Still the interest are continues to be high.

2. The Bank has also been criticized for is failure to meet the financial needs of the developing countries requirements for their economic and social uplift. In order to increase the Bank funds to such countries, it established the International Development Association (IDA) in 1960. Despite this, the Bank has not been successful in raising the productivity and standard of living of their people. Its lending operations account for only a small proportion of the total net aid to developing countries. The loans to the poorest countries in fiscal year 1984 were 2.3 per cent of the total loans.

3. The Bank's lending procedure is faulty because it lays emphasis on the repaying capacity of the borrowing country before granting and loan. Such a condition is very harsh and discriminatory for developing countries which are poor and need financial help on a large scale. In fact, the repaying capacity of a poor country follows the utilization of a loan. As the project is completed

with the loan assistance, the repaying capacity of the borrower increases gradually.

4. The Bank has been criticized for being discriminatory in its purpose wise and region-wise assistance to its members. Till the 1960s the bank's lending operations concentrated heavily upon capital infrastructural projects in such countries as Australia, Japan, Italy, and several other European countries. The loans for infrastructural investments accounted for 74 per cent of total loans up to 1971-72 on the average. Since than, the lending policy of the Bank has been directed more toward the developing countries and, for the development of agriculture and rural development, energy, transportation, communication, water supply, sewerage, etc.

5. The introduction of SAF since 1985 has made IBRD loans terms tighter. The borrowing country is required to follow an action programme set out in a letter of development policies such as open trade, reform in public budgeting and debt management, revision of price policies, better planning of public investment and management of public enterprises, etc. The Second tranche of SAF is only released after a review of the reform programmes that are date-bound.

7.9.11 India and the World Bank

India is one of the founder members of the Bank and held a permanent seat on its Board of Executive Directors for a number of years. The Bank has been assisting India in its planned economic development by granting loans, conducting field surveys, rendering expert advice, sending missions, study terms, and training Indian personnel at the EDI. There is also a Chief of Mission of the Bank at New Delhi who represents it for monitoring and consultation on it aide's projects in India. India has been the largest receiver of the World Bank assistance since August 1949. the World Bank had committed 16 loans to India totaling $ 2,128 million till June 1988. In 1987, India borrowed $ 2.13 billion from the IBRD, $ 678 million from the IDA, and about $ 2 billion from commercial sources. The World Bank has been assisting India in such Projects, aircrafts, coal, iron, aluminum, fertilizers, railway modernization, technical assistance, industrial development finance cooperation's, etc.

7.10 SUMMARY

The Aid India Consortium of twelve developed countries has been giving aid to India for its development plans at the instance of the World Bank. The Bank also helped India to solve amicably its river water dispute with Pakistan.

India has thus gained much for being the member of the World Bank for the development of agriculture, industry, energy and transport. But with reduced availability from the IDA, India will have to borrow more from the Bank in future. The will entail heavy burden on India's resources for the terms of IBRD loans are much harder than IDA credits.

7.11 KEYWORDS USED IN THE LESSON

International finance

International Monetary fund

EXIM

ECGC

World Bank

7.12 ANSWERS TO CHECK YOUR PROGRESS QUESTION

1 Quotas.

2 UNO.

3 Reserve tranche

4 Two

5 1966

7.13 MODEL QUESTIONS

1. Bring out the main functions of International Monetary Fund.
2. What is Structural Adjustment Facility?

3. What do you understand by Joint Venture?
4. Bring out the objectives of ECGC.

Essay Questions

1. Discuss in detail about IMF.
2. Examine the operations of EXIM Bank.
3. Examine the various functions of Asian Development Bank.
4. Bring out the various insurance schemes offered by the ECGC to promote international trade.

7.12 FURTHER READING

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Ch audhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

NOTES

UNIT – VIII

INTERNATIONAL FINANCIAL INSTITUTIONS AND INDIA

UNIT STRUCTURE

8.1 Introduction

8.2 Unit Objectives

8.3. International Bank for reconstruction and development

8.4 International Finance Corporation

8.5. EXIM Bank of India

8.6. International Development Association

8.7 Industrial Credit and Investment Corporation of

8.8 International Monetary System

8.9 Special Drawing Rights

8.10 Devaluation

8.11 Central Bank

8.12 Summary

8.13 Key words used in the lesson

8.14 Answers to check your progress questions

8.15 Model Questions

8.16 Further reading

8.1 INTRODUCTION

In its initial days the World Bank concentrated on reconstruction of the war shattered began to receive prime importance. Later the Bank shifted its focus and „development" of the backward countries began to receive prime importance. As an inter-government agency for lending for development, the bank is mobilizing large-scale

resources of private investors of the world"s capital markets for investment in the developing countries.

8.2 OBJECTIVES

1. To identify the various financial institutions operated in India

2. to examine the role of financial institutions operated in India

8.3 INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Also known as World Bank, the IBRD is an offshoot if the Brettonwoods Conference of 1994. Its main function is to provide long-term capital assistance to its member-countries for their reconstruction and development.

8.3.1 Functions

The main functions of the Bank are:

To assist in reconstruction and development of the territories of its member-governments by facilitation investment of capital for productive purposes;

To promote foreign private investment by guarantees of or through participation in loans and other investments of capital for productive purposes; where private capital is not available on reasonable terms, to make loans for productive purpose out of its own resources or out of the funds borrowed by it; and

To promote the long-rang growth of international trade and the maintenance of equilibrium in the balance of payments of members by encouraging international investment for the development of the productive resources of members.

The bank has adopted as its principal objective lending for productive projects which will lead to economic growth in its less developed member-countries.

8.3.2 Lending Activities

The Bank can make or facilitate loans in any of the following ways:

.By making participating in direct loans out of own funds raised in the market of a member, or otherwise borrowed by the bank; and

By guaranteeing in whole or in part loans made by private investors through the usual investment channels.

In short, the Bank may make loans directly to member-countries or it any guarantee loans granted to member-countries. The Bank normally makes loans for productive purposes like agriculture and rural development, power, industry, transport, etc. The total amount of the loan granted by the Bank should not exceed 100% of its total subscribed capital and surplus. The interest rate charged by the bank is the estimated cost to the Bank of borrowing money for a comparable term in the market and is uniform without distinctions being made among borrowers. In addition to interest, commission of 1% for the purpose of creating special reserve against loss and +% for administrative expenses are charged.

In guaranteeing loans the Bank acts as a bridge between the donors and recipients of foreign and for development. The Bank is continuously involved in the assessment of the creditworthiness of the recipients of aid and convinces the foreign investors that the political and economic climate for investment is favourable. It coordinates aid-giving activities of the Western countries. It has organized „consortia" for centralizing the flow of foreign aid so that the recipients of aid do not play one aid giver against the other. At the same time, it is actively involved in helping the developing countries to identify appropriate projects for development which can be financed by the world investors.

The Bank adopts the following policies in respect of its loans and guarantees:

All loans are made to governments or they must be guaranteed by governments;

Repayment is to be made within ten to thirty-five years;

Loans are made only in circumstances in which other sources are not readily available; Investigations are made of the probability of repayment, considering

both the soundness of the project and the financial responsibility of the government;

Sufficient surveillance is maintained by the Bank over the carrying out of the project of assure that it is relatively well executed and managed;

Loans are sanctioned on economic and not political consideration;

The loan is meat to finance the foreign exchange requirements of specific projects; normally the borrowing country should mobilize its domestic resources.

Two aspects of lending activities of the Bank deserve to be highlighted. [Bhambhri, C.P., "World Bank and India", Vikas Publishing, 1980, p.59.] First, since the Bank has to finance high-priority productive sectors of economies and determine „creditworthiness" of the borrowers, it makes detailed studies through its Mission and Resident Representatives of the economy of the recipients of aid. The Bank"s comprehensive and limited pre-investment surveys, which are financed either by the Bank or the UNDP, have created a situation where the headquarters of the Bank has become a „monitoring" centre of the economies of the borrowing countries.

Secondly, the Bank"s dependence for resources on capital markets of the world influences its economic and social philosophy which is based on the doctrine of „free enterprise".

8.3.3 Organization

IBRD is inter-governmental organization. Only governments or various countries can become its members. The total membership of the Bank at the end of June 1994 was 177. The management of Bank is on the same lines as that of IMF, with a Board of Governors, Executive Directors and a president. Of the 22 Executive Directors, 5 are nominated by the 5 biggest shareholders-USA, UK, FRG, Japan and France. Remaining directors are responsible for general operations of the Bank and meet every month. The President act as the Chairman of the Board of Directors. The ultimate authority is the Board of governors is which all member-States are represented. Voting rights of

which they represent. Therefore the policies of the Bank tend to get influenced by the opinions of the largest shareholders.

8.3.4 Resources

Resources of the Bank consist of the Capital and borrowings. Initially the authorized capital of the World Bank was $ 10,000 shares of $ 1,00,000 each. Of the share capital-

2% is payable by the member-country in gold or US dollars. This portion is freely available for lending;

18% is payable member"s own currency. This portion is available for lending with the consent of the member whose currency is involved; and

80% is kept in reserve to be paid by the member when called.

Thus only 20% of each member"s subscription is available to the Bank for lending activities. The balance 80% is serving as guarantee resources backing up the Bank"s borrowing operations in international markets. The capital of the bank has been revised upwards in keeping with the increased lending activities of the Bank, and by July 1, 1994 it stands at US$ 170 billion.

Besides lending activities, the Bank renders a variety of technical assistance involving full-scale economic survey of the development potential member-countries or advice on particular projects. It has done a useful function in settlement of international economic problems such as nationalization of the Suez Canal. Most of its landings have gone to developing countries, India being the single largest borrower. But, it is pointed out that difficulties are faced by developing countries in obtaining finance from it. The Bank"s policy of requiting guarantee from the government or the central bank of the country for loans granted to private enterprises has also been hindering large-scale assistance to private enterprises. The interest rate charged is said to be high in comparison with the returns from the projects for which the loans are made. However, it

cannot be denied that the Bank has been rendering a useful service especially for the economic development developing countries.

8.4 INTERNATIONAL FINANCE CORPORATION

The IBRD loans are available only to member-country governments or with the guarantee of member-country governments. Further, IBRD can only make a loan but in cannot participate in the equity of the project finance. The international Finance Corporation (IFC) was established in 1956 with the special purpose of financing private enterprise. It is an affiliate of the IBRD.

Check Your Progress

1 The international Finance Corporation (IFC) was established in the year_____.

8.4.1 Organization

Only member of the World Bank can become members of IFC. The Board of Governors of the IBRD also constitutes the Board of Governors of the IFC. But it is a separate entity with funds kept separate from those of the IBRD.

The powers of IFC are vested in the Board of Governors which normally meets once in a year. The 22 Executive Directors of the World Bank constitute the Board of Directors of the IFC, responsible for its general operations. The president of IBRD is the Ex-officio chairman of the Board of Directors of IFC. The day-to-day operations are conducted under the direction of the Executive Vice-president.

8.4.2 Function

The purpose of the IFC is to further the economic development by encouraging growth of private enterprise in member-countries, particularly in the less developed areas, thus supplementing the activities of the IBRD. The IFC, therefore,

Invest in private enterprise in member-countries, in association with private investors and without government guarantee, in cases where sufficient private capital is not available on reasonable terms;

Seeks to bring together investment opportunities, private capital of both foreign and domestic origin, and experienced management; and

Stimulates conditions conducive to the flow of private capital, domestic and foreign, into productive investment in member-countries.

The IFC makes advances in the form of long-term loans or invests in the equity shares in a wide variety of productive private enterprises in developing countries. It particularly encourages joint ventures between developed and developing countries, the technical skill available with the former combining with the resources available with the latter. The project which IFC for a unit would not be less than $ 1 million and not more than $ 100 million. Further IFC, s investment normally does not exceed 50% of the total investment of the enterprise. In case of its investment by equity contribution, it does not exceed 25% of the share capital. The interest charged on advances varies depending upon the proposal and stature of the borrower.

Beside direct lending and participation in equity capital, IFC also undertakes certain developmental activities. The activities include:

Check Your Progress

2 **EXIM** Bank provides only_____ and _____term financing,

8.5 EXPORT-IMPORT BANK OF INDIA

(Based on pamphlets and Annual Report of Exim Bank)

The Export-import Bank of India (Exim Bank) is a public sector financial institution, established on January 1, 1982. It was established by an Act of Parliament. For the purpose of financing, facilitating, promoting foreign trade of India. It is the principal institution for coordination the working of institutions engaged in financing export and import. The Exim Bank Act also empowers the Bank of finance export of consultancy and related services assist Indian joint ventures in third countries, conduct export market studies, fiancé export-oriented industries and provide international merchant banking services. Exim Bank concentrates on medium and long-term financing, leaving the short-term financing to be handled by commercial banks. The Activities of the Bank extend to different fields of lending, offering advisory services and promotional activities.

8.5.1 Functions of EXIM Bank

Lending

Guaranteeing

Advisory

Preparatory

8.5.1.1 To Indian Companies

1. Seller Credit
2. Consultancy and Technical Services
3. overseas Investment
4. Pre-shipment Finance
5. Export-oriented Units and Free Trade Zones
6. Computer Software
7. Export Marketing Fund
8. Export Product Development
9. project Preparatory Service overseas

8.5.1.2 To Foreign Govt. Companies, etc.

1. Buyer"s Credit
2. Lines of Credit
3. Re-lending Facility

8.5.1.3 To Indian Banks

1. Bill Rediscounting

2. Re-finance
3. Syndication of Risks
4. Bulk Import Finance

8.5.2 Lending to Indian Exporters

8.5.2.1 Supplier's Credit

Funds are provided, on deferred payment terms, to Indian exporters of plant, equipment and related services, which enable them to extend deferred credit to the overseas buyer. This programme covers project exports which could be turnkey project or construction project.

As already noted in the previous chapter, the credit extended to exporter on deferred payment terms is subject to the stipulation of the Reserve Bank with regard to period of credit, quantum of finance, etc.

The credit is provided by Exim Bank in participation with commercial banks. Where individual contract value in not more than Rs. 3 crores, banks may provide the credit and avail 100% refinance from Exim Bank.

The exporter is expected to obtain an advance and down payment of at least 15% of the contract value. Down payment and payment of deferred installment should be secured by a letter of credit and/or a guarantee from a bank in the country of import or any third country as may be acceptable to Exim Bank. Where the importer is a government department of public sector undertaking, a guarantee from the government and/or promissory note from the government and/or undertaking may be acceptable. In order to ensure release of foreign exchange according to the agreed schedule, a letter from the central bank of concerned foreign country, giving a undertaking regarding prompt release of exchange towards the receivable, may be required.

The exporter is expected to forward to the Exim Bank estimated quarterly drawal schedule of entire credit amount, well before the commencement of credit utilization.

Exim Bank will finalize the overall credit drawal schedule and the terminal date for drawal taking into account the delivery schedule under the export contract.

The disbursement requests will be forwarded to Exim Bank by the sponsoring/participating/negotiation bank along with non-negotiable copies of all documents under the relative letters of credit/export contract and certifying that the documents have been duly negotiated by them. The disbursement will be made to the exporter by Exim Bank through the sponsoring/participating/negotiation bank.

8.5.2.2 Consultancy and Technology Services Finance Programme

Indian consultants, executing overseas contracts involving consultancy and technology service, wherein deferred payment terms need to be offered to the client, can utilize the facility. The credit will be extended by Exim Bank in participation with commercial banks.

The exporter is normally expected to obtain an advance/down payment of 25% for contract value and remaining portion would be covered by credit under the programme. The currency of the credit would normally be Indian rupees. Loans in other currencies can also be considered, if required.

The loan is to be secured by guarantee of foreign government of a guarantee irrevocable letter of credit of a bank acceptable to Exim Bank. The exporter would also be required to obtain ECGC insurable cover.

Check Your Progress

3 Under Consultancy and Technology Service Finance Programme, the exporter is normally expected to contribute down payment of _____ for contract value.

8.5.2.3 Overseas Investment Financing Programme

Exim Bank provides financing, where an Indian company established a joint venture overseas and requires funds towards equity participation. The joint venture should have been approved by the Government of India as well as the concerned authorities in the host country. Rupee funds are provided by Exim Bank in the form of long-term credit normally not exceeding ten years. The equity shares issued to the Indian promoter are required to be pledged to Exim bank together with a mandate/assignment in its favor in respect of receivables arising from know-how/management fees, royalties,

dividends, etc., on the assets of the promoters in India also personal guarantees. The Indian promoters are required to obtain the ECGC"s overseas Investment Policy and assign it in favor of the Exim Bank/participating bank.

8.5.2.4 Pre-shipment Credit

Credit is available to eligible exporters to buy raw materials and inputs required to produce capital equipment that has to be exported. Exim Bank participates in the Credit, if the requirement is for periods in excess of 180 days. Pre-shipment credit up to 180 days is available from commercial banks and, therefore, Exim Bank not entertains proposals not exceeding this period.

8.5.2.5 Export-oriented Units

Units registered as 100% export-oriented units, units setup to be set up in free trade zones and Domestic Tariff Area (DAT), units exporting minimum 25% of their annual sales are eligible for financial assistance from Exim Bank for acquisition of land, building, plant and machinery and preliminary/pre-operative costs.

Exim Bank"s assistance may be in the form of direct lending or refinance. Direct lending may be by way of rupees term loans. Refinance is extended to commercial banks in cases involving project cost of Rs. 3 crores and below. Where project cost exceeds Rs. 3Crores, Exim Bank provided finance in participation with all India financial Institutions/Commercial Banks.

8.5.2.6 Computer Software Exports

Under the Government of Indian policy on computer Software Exports and Development. Exim Bank has been designated as an agency for facilitating speedy clearance and meeting foreign exchange requirements towards imports for computer software export where export obligation of 35% of foreign exchange is undertaken.

Exim Bank offer an integrated package covering foreign currency and rupee term finance for acquisition for imported and indigenous compute/computer-based systems for export purpose. Foreign currency loans are made available for financing import of

computer systems and equipment and rupee term loans for acquiring indigenous computer/computer-based systems and other assets for export purpose.

Exim Bank under takes financial and technical analysis of software export proposals and monitors the progress of software exports. It arranges for clearance or imports and finance under one window.

8.5.3 Export Marketing Fund

Export Marketing Fund is a component of World Bank loan to India for industrial export, Government of India has designated Exim Bank as the agency to manage the fund.

Private sector companies and joint sector companies, who have the overall resources, capability, potential, top management commitment and an export strategy to penetrate and retain presence particularly in developed country markets and engaged in manufactured export of computer software, are eligible for assistance.

The company level activities eligible for assistance include desk research overseas field market research, minor product adaptation, overseas travel, product inspection service, training, establishing overseas operations, travel to India buyers overseas, front-end promotional expenditure, research and development, equipment for plant modernization/capacity expansion, tooling, jigs and fixtures, and testing control equipment.

Finance is available in foreign currency up to 50% of the cost of the eligible activities covered by grant finance. Term loan in rupees, subject to a maximum of equivalent of USD 1 million, is available for finance activities not covered by grant finance. (Grant finance is available for front-end activities which from part of a systematic market entry plan.)

8.5.3 Export Product Development The scheme enables Indian firms to undertake product development, research and development, research and development for exports.

Project Preparatory Services Overseas

The scheme is to provide loan/grant finance for using Indian consultancy in puts at preparatory stages in projects overseas. The programme is designed to support studies covering the following stage: pro-investment, project formulation, project implementation. Typical sectors for which assistance can be considered include agriculture/agro industry/energy industry/water supply and sewerage/eduction/helth. Maximum loan is Rs.20 lakhs grant Rs.10 lakhs.

8.5.4 Lending to Foreign Government, Companies, etc.

8.5.4.1 Buyer's Credit

Credit is extended by Exim Bank to buyers abroad to enable them to import engineering goods and projects from Indian on differed credit terms. Similar to direct lending to exporter, the facility is to be secured by a letter of credit or bank guarantee of guarantee from government or promissory note from government. An undertaking letter from the central bank of the country regarding prompt release of exchange towards receivables may also be required.

Exim Bank will directly enter into an agreement with the overseas borrow outlining the terms and conditions of the credit covering the export contract.

8.5.4.2 Lines of Credit

Exim Bank extends lines of credit to overseas governments or agencies nominated by them, to enable buyers in these countries to import capital/engineering goods from India on deferred credit terms. This facility enables Indian exporters to offer deferred credit to customers in these countries, as per terms and conditions already negotiated between Exim Bank and the overseas government. The exporter can obtain payment from Exim Bank against negotiation of shipping documents, without recourse to the exporters.

The facility is available to sovereign governments or agencies nominated by them. Such government/agencies are deemed to be the borrowers, with Exim Bank as the

lender. Terms and conditions of differe nt lines of credit are subject to variation and particulars can be obtained for each line of credit from Exim Bank. It would also need to be ascertained from time to time that the lines of credit have come into effect and are available for utilization.

The buyer arranges to obtain allocation of funds under the credit line from the borrower, the exporter then enters into contract with the buyer, for the eligible items covered under Line to Credit. The contracts would conform to the basic terms and conditions of the respective line of credit.

The buyer arranges to comply with procedural formalities as applicable in his country and then submits the contract to the borrower for approval. The borrower in turn forwards copies of the contract to Exim Bank for approval.

The Exim Bank advises approval of the contract to the borrower, with copy to the exporter. The buyer, on advice from the borrower, establishes an irrevocable letter of credit and advises it through a bank in India designated by Exim Bank.

On shipment, the exporters submit the documents to the designated bank for negotiation. Bank forwards documents to the buyer and copies of the documents to Exim Bank reimburse the eligible value to the negotiating bank for onward payment to the exporter. In then debits the borrower"s account and arranges to collect interest and principal receivable on due dates under the terms of the line of credit agreement between Exim Bank and the respective government agency.

8.5.4.3 Re-lending Facility

Credit made available to overseas banks for their lending to importers of capital goods from India. Overseas banks thus would intermediate between foreign buyer and Exim Bank, who intermediates with the supplier.

The borrowing bank may be a commercial bank, a central bank, an investment bank or merchant bank of a country with good credit standing. The loan made by these banks to the importers should be for import of capital goods/equipment and/or services

from India. The credit limit for each bank would normally be USD 5-10 million and may be raised to USD 15 million in selected cases.

The loan is extended up to 85% to 90% of any single contract. The limit sanctioned should be availed of within 1 year from effective date of agreement. The repayment period may vary from 2 to 5 years including a moratorium of 6 months to 1 year. The currency of the loan is US dollars and 5 years including requirement should be in the same currency. The minimum value of contract should be USD 1 lakh.

The borrowing bank will make sub-loans, within its own discretion, in developing countries with which India has trade relation. Repayment period of sub-loan should be in conformity with the loan. Interest rate charged by the borrowing bank in to be not higher than 1% above the loan interest rate, unless Exim Bank agrees otherwise. The borrowing bank will take the political and credit risk on the end borrower.

Check Your Progress

4. The repayment period provide under re-lending facility may vary from _____.

8.5.5 Loans to Commercial Bank in India

8.5.5.1 Refinance of Export Credit

Under this programme, commercial bank in India, who are authorized dealers in foreign exchange, can obtain from Exim Bank 100 per cent refinance term loans extended for export; of eligible Indian goods. Such credit enables Indian exporters to offer credit terms to foreign importers. An export contract up to RS. 3 crores can alone be brought under this programme. For contracts above Rs.3 crores, commercial banks can obtain financing participation under Exim Bank"s other programmes, including Risk syndication facility.

Export Bill rediscounting Facility

Commercial bank (authorized dealers) can rediscount their short-term usance export bills portfolio with Exim Bank provides funds this programme for a period of 90 days against export bill the have equal period to run before realization. The bill eligible for rediscount should have an unexpired usance of 90 days. Or rediscount the commercial bank is paid 100% of the bill value (less rediscounting charges).

8.5.5.2 Syndication to Export Credit Risks

Under this commercial banks can support export proposals without blocking their funds for long terms. They can participate in the syndication arrangement.

At the Working Group meeting which accords clearance to the export proposals, the participation arrangement for the funding of export credit is also determined. Exim Bank and other banks participating in the funding of the loan would syndicate the respective credit risks to other eligible commercial banks, who would then assume part of the total risk.

Risk will be assumed by risk participating banks as a percentage of the credit extended for a particular contract, expressed in Indian rupees, irrespective of the currency of the contract. The risk is assumed pro rate on all outstanding amounts by way of principal, interest and other moneys which become due and payable by the borrower.

Commission is payable in advance by risk selling bank/funding bank to risk participating bank, every half year, till due repayment date at 0.5% p.a. pro rate on outstanding principal amount, plus interest accruing for the period.

Export credit is secured by securities availed from the exporter/foreign importer as well as ECGC policy. Risk participating banks can looks to these securities, and amounts received would be distributed pro rate to participants, who may have met claims against risk undertaken.

Risk participating banks are expected to furnish in fovour of Exim Bank/Risk selling banks a standby letter of credit, guaranteeing to assume proportionate risk and play on demand in the event of any default by borrower.

8.5.6 Bulk Import Finance

Bulk imports of consumable inputs and canalized items imports made on short-term credit/cash basis and imports of plant/machinery for domestic production are financed by commercial banks and term lending institution. Under this scheme, promissory notes drawn in favor of commercial banks by their importer customers are

discounted. Exim Bank will issue letter of commitment for finance on request from commercial banks indicating their requirement. The quantum of finance depends on the condition that import order should not be less than Rs. 1 crore.

8.5.7 Non-Lending Services

Guaranteeing of Obligation

Exim bank issues guarantees on behalf of exporters of construction and turnkey projects. Guarantees issued by Exim Bank include:

Check Your Progress

5 Under Guarantee Facility for Banks scheme, Exim Bank extends guarantee to commercial banks against the post-shipment supplier"s credit-from_____.

(i) bid bond guarantee

(ii) advance payment guarantee

(iii) performance guarantee

(iv) retention money guarantee

(v) guarantee for borrowings abroad and

(vi) Other guarantees, i.e., in lieu of customs duty, Exim Bank participates with commercial banks in India in the issue of guarantee.

8.5.7 Guarantee Facility for Banks

Under this scheme Exim Bank extends guarantee to commercial banks against the post-shipment supplier"s credit-from one year to three years – and the amount of cover is equivalent to the amount covered by the exporter under ECGC. The guarantee commission payable by the bank as per the FEDAI rule is 1.8% on an annualized basis.

Banks can avail refinance facility from Exim Bank at 1% lesser than the RBI facility. In case of defaults, the guarantee will be converted to a refinance facility and the interest rate charged will be 2% below the rate charged by the banks to their customers, subject to a minimum of 13% per annum. Since Exim Bank will pay under the guarantee within 30 days, it will protect the loan asset from being classified as non-performing asset

by the bank. Also, if the claim is rejected by ECGC, the amount will be written off by Exim Bank and the commercial bank will not be liable to repay.

8.5.8 Advisory Services

Thorough its international Merchant Banking Division, Exim Bank offers the following advisory services:

Work closely with Indian companies in designing financing package for joint ventures in countries;

Advise Indian companies, executing contracts abroad, on sources of favourable financing overseas;

Provide access to euro financing sources and global credit sources to Indian companies engaged in exports;

Advice and design financial packages for export-oriented industries in India.

These services are being added to, in order that tailor-made financing packages for high value export contracts are available.

8.5.9 Promotional Activities

Under the Export Import Bank of India Act, 1981, the promotional activities expected of Exim Bank are:

Undertaking and financing or research, surveys, techno-economic or another study in connection with the promotion and development of international made;

Providing technical, administrative and financial assistance of any kind for export and import.

Planning-promoting, developing and financing export-oriented concerns; and

Collecting, compiling and disseminating market and credit information in respect of international trade.

8.5.10 Forfeiting

Factoring and Forfeiting

Factorings is the system of advancing against book debts. Factoring involves assignment of book debts by clients in favour of the factoring company for a consideration. The factor assumes the credit and collection function for its client by purchasing his receivables, maintaining the sales ledger, attending to other book keeping duties and performing ancillary functions.

Factoring differ from bills discounting inasmuch as the factor purchases the entire debts of the unit and is responsible for their collection, while in bills discounting the credit risk rests with the seller. Factoring can be with or without recourse but the former is more common. For the customers (sellers) factoring affords a number of advantages like availability of a liquid cash immediately after sales, reduction of bad debts, education in the cost of managing book debts, etc. factoring can be both for domestic and export trade. Following the recommendation of a Study Group on Factoring Services headed by Shri C.S. Kalyanasundaram, Reserve Bank has permitted few subsidiaries of banks to undertake the factoring service.

Forfeiting is similar to export factoring with a difference that while export factoring is generally for short term, forfeiting is for medium term to cover exports on deferred basis. Forfeiting affords advantage of better liquidity and faster turnover of resources, avoidance of credit risks, elimination of exchange risks etc., to the exporter.

8.5.11 Forfeiting by Exim Bank

Exim Bank has introduced a scheme of forfeiting as an instrument of financing exports. The arrangement envisages discounting by Indian exporter of bills of exchange/promissory notes relating to export transactions which are „availed" or guaranteed by the buyer"s bankers with overseas forfeiting agencies on „without recourse; basis.

Briefly, the procedure involved in the scheme of forfeiting by the Exim bank is as follow:

Exporter initiates negotiations with the prospective overseas buyer with regard to the basic contract price, period of credit, rate of interest, etc.

After successful negotiations, he furnishes the relevant particulars such as name and country of overseas buyer, contract value, nature of goods, tenor of credit, name and country of guaranteeing bankers to the Exim bank requires for an indicative discounting quote. Exim Bank obtains the indicative quote of forfeiting together with commitment fee and other charges. If any, to be paid by the exporter, from and overseas forfeiting agency.

On receipt of the indicative quote from the Exim Bank, the exporter finalizes the terms of contract, loading the discount and other charges in the value and approaches Exim Bank for obtaining a firm quote Exim Bank arranges to get same from an appropriate overseas forfeiting agency and furnishes the same from exporter. At this stage, exporter would be required to confirm acceptance of the arrangement to Exim Bank within a specific period as stipulated by the bank.

The export contract should clearly indicate that the overseas buyer and prepare a series of availed promissory notes in favour of the exporter and know them over against the shipping documents to his banker. The promissory notes will be endorsed words „without recourse" by the exporter and handed over to his banker in India for onward transmission to the Exim Bank.

Alternatively the export contract may provide for exporter to draw a sense of bills of Exchange on the overseas buyer which will be sent with the shipping documents through latter"s banker for acceptance by the overseas buyer. Overseas buyer"s banks will handover the documents against acceptance of bills of exchange by the buyer and signature of „avail" or the guaranteeing bank. Availed and accepted bills of exchange will be returned to the exporter through his banker. Exporter will endorse availed bills of exchange with the words „without recourse" and return them to his banker for onward transmission to the Exim Bank.

Exim Bank will forward the bills of exchange/promissory notes after verification to the forfeiting agency for discounting by the latter.

Exim Bank will arrange to collect the discounted proceeds of promissory notes/bills of exchange from the overseas forfeiting agency and effect payment to the account of the exporter"s bank as per the latter"s instructions.

The role of Exim Bank is an intermediary between the Indian exporter and the overseas forfeiting agency. Exim Bank will received availed bills of exchange or promissory notes, as the case may be, and send them to the forfeiter for discounting and arrange for crediting the discounted proceeds to the account of the exporter"s bank who will repatriate the proceeds to India for payment to the Indian exporter.

Exim Bank will issue a certificate to the exporter with a copy to his bank indicating the rate of forfeiting discount. While completing the respective GR/PP form (s), the exporter should indicate the total invoice value of the goods inclusive of the forfeiting discount and should show the amount of discount against the item „other deductions" to arrive at net realizable value. Copies of these certificates should be attached to both the copies of GR/PP form.

Exim Bank will also issue a certificate to the exporter, once the exporter accepts the firm forfeiting quote, indicating the rate of commitment fee payable by the exporter to the overseas forfeiting agency together with other service charges, if any. If would be in order for authorized deals to allow remittance of commitment fee/service charges payable by the exporter as certified by the Exim Bank. Such remittance may be permitted in advance in one lump-sum or at monthly intervals as certified by the Exim Bank. Payment of this fee may be treated analogous to bank charges. In case, however, the commitment fee and other charges exceed 1.5% of the invoice value, the exporter should be advised to obtain prior approval of the Reserve Bank of India. Exim will charge a service fee for rendering above services to the Indian exporter, which will be payable in Indian rupees.

8.5.12 Exim Bank – Lending and Service Programmes

Programme use for Indian Entities

Export (Supplier's) Credit

Enable Indian exporters to extend term to overseas importer, of eligible Indian goods. Finance for Consultancy and Technology Services Enable Indian exporters of consultancy and technology services to extend term credit to overseas importers. Pre-shipment Credit Enable Indian exporters to buy raw material and other inputs for export contracts involving cycle time exceeding six month. Finance for Deemed Exporter Enable Indian companies to meet cash flow deficits of contracts secured in India and financed by multilateral funding agencies. Foreign Currency Pre-shipment Credit Enable eligible exporters to access finance for import of raw materials and other inputs needed for export production. Finance for EOUs & Units in EPZs Enable Indian companies to acquire indigenous and imported machinery and other assets for export production. Foreign Currency Lines of Credit for Imports Enables eligible export-oriented units to acquire imported machinery for export production. Export Vendor Development Finance Enable vendors of export-oriented units to acquire plant and machinery and other assets for increasing export capability. Export Product Development Enable Indian firms to undertake product development, R & D for exports. Overseas Investment Finance Enable Indian promoters to finance equity contribution in joint ventures/WOS set up abroad. Software Training Institute Enable setting up to institutes for software training. Export Marketing Finance Enable exporters to implement market development programmes and finance productive capabilities through loan financing. Production Equipment Finance Enable eligible export-oriented units to acquire equipment Services.

8.5.13 Underwriting

Enable Indian exporter to raise finance from capital markets through public/rights issues of equity shares/debentures with the backing of Exim Bank"s underwriting commitment. Forfeiting Enable Indian exporters to convert credit sale to cash sale on without recourse basis. Guarantee Facility Enable Indian companies to provide requisite guarantees to facilities execution of export contract and import transactions. Project

Preparatory Service Enable Indian consultancy firms to undertake project preparatory studies in developing countries by grant/loan financing. Business Advisory & Technical Assistance Services Overseas Enable Indian consultancy firms to undertake specific assignments in select countries through grant financing. Cooperation Arrangement with African management Services Co. (AMSCO), Enable Indian consultancy to secure assignments in various projects that are managed by AMSCO in different parts of Amsterdam Sub-Saharan Africa, through grant financing. An Africa Project Development Facility Enable Indian consultancy firm to undertake specific assignments to assist small and medium entrepreneurs is Sub-Saharan Africa. EC Investment partners Facility Enable setting up of joint ventures in India between Indian companies and enterprises in the European Community. For Commercial Banks.

8.5.14 Refinance of Export (Supplier's) Credit

Enables banks to offer credit to Indian exporters of eligible goods, who extend term credit of over 180 days to importers overseas. Export Bills Rediscounting Enables banks to rediscounting bills, with usance not exceeding 180 days. Small Scale industry (SSI) Export Bills Rediscount Export Enables banks to rediscount export bills of their SSI customers with usance not exceeding 90 days. Re-lending facility Enables banks overseas to make available term finance to their clients, for import of eligible Indian goods. Refinance of Term Loans to EOUs Enable banks to offer credit to eligible of export-oriented units to acquire indigenous and imported machinery and other assets for export production. Bulk Import Finance Enables banks to offer finance to importers for bulk import of consumable inputs. Guarantee-cum-Refinances Supplier"s Credit Enable banks protect their own cash flow as also its exporter client"s cash flow on account of default by overseas buyer. Protects the Bank by not treating the Advance as a Non-Performing Assets fro provisions purpose. For overseas Entities.

Lines of Credit

Enable overseas financial institution, foreign governments, and their agencies to on lend term loans to finance import of eligible goods from India. Buyer"s Credit Enables overseas buyer to import eligible goods from India on differed credit terms.

8.5.15 ECGC Guarantees on Whole Turnover Basis

The two most popular guarantees issued by ECGC are the packing credit guarantee and post-shipment guarantee. As a further incentive to large-scale use of these guarantees, ECGC offer them on whole turnover basis also. when a bank oopts for whole turnover packing credit guarantee or whole turnover post-shipment guarantee, it agree to cover under the scheme all eligible advance by declaring them to ECGC and paying premium on monthly basis.

The advantages that emanate from the use of whole turnover guarantee schemes are mainly three:

(i) the bank gets higher percentage of cover

(ii) the rate of premium is reduced and

(iii) the trouble of getting individual guarantees is avoided.

Whole Turnover Packing Credit Guarantee

The salient features of Whole Turnover Packing Credit Guarantee (WTPCG) are us under:

Advanced covered. The WTPCG is issued to a bank if it is prepared to cover under the guarantee all its packing credit advices with the exception of packing credit advances to (a) small-scale industrial units, and (b) Government of India enterprises. No exception is available for advances granted to state government of joint sector units.

Premium. The rate of premium on the guarantee is 6 paise per Rs. 100 per month as against 10 paise in the case of individual packing credit guarantee. Further, the guarantee fee is calculated on the average daily product instead of on the highest balance outstanding in the month.

Illustration

During April, a packing credit account had the following balance:

On 1st Rs. 50,00

On 10th Rs.60,000

On 22nd Rs.90,000

The premium can be calculated as under:

50,000 x 9 days = 4,50,000

60,000 x 12 days = 7,20,000

90,000 x 9 days = 19,80,000

19.80.000 / 30 = Rs.66, 000

Premium at 6 paise per Rs. 100 = (66,000 x 6) / (100 x 100) = Rs. 396

Enter of cover. The extent of cover provided is 75% as against the normal 66 2/3%. In respect of advances to small-scale exporters with annual export turnover not exceeding Rs. 10 lakhs and his total annual turnover not exceeding Rs.25 laksh, the extent of cover is 90%.

Discretionary limit. Every guarantee mentions a limit up to which the bank can allow packing credit advances to any of its exporter-clients without ECGCs approval. This limit, known as the „discretionary limit", varies from bank to bank and may change from one guarantee year to another. All limits in excess of the discretionary limit need the approval of ECGC. If this approval is not obtained, the Corporation"s liability is limited to the extent under the discretionary limit.

Declarations. A packing credit gets the cover under the guarantee by its declaration in the form specified and payment of premium to the Corporation. The

money declaration along with the premium is to be submitted by the Head/zonal/Regional office of the bank before the end of the succeeding month.

Annual statement. A complete statement of limits in force at the commencement of the guarantee is to be furnished to the Corporation by the Head Office of the bank while obtaining the WTPCG for the first time. Annual statements are thereafter to be furnished as on 30th September each year. Whenever new limits are sanctioned or existing limits are enhanced, reduced or cancelled, they should be reported to the Corporation immediately but in any case within 30 days.

Specific approval list. The Corporation issues once a year a list containing names of exporter"s advances to whom will be covered only on specific approval of the Corporation being obtained by the bank. The approval is required even if the limit is within the discretionary limit of the bank.

Advance against incentives. For banks which have taken WTPCG, the concession of reduced premium and extended coverage of 75% is also available to advances made by them at the pre-shipment stage under export production finance guarantee. Declaration should be submitted separately under the export production finance guarantee on these bases.

Default report. If the bank, apprehending losses in an account, stops granting fresh advances it should recall the balance outstanding in the account and send a „report of default" to the Corporation. Within 30 days. Premium need not be paid on a account after the occurrence of default. The bank should keep the Corporation informed of the recovery action taken by it. It should also take such other steps as may be suggested by the Corporation.

Nursing programme. If in respect of a defaulted account, the bank agrees for a nursing programme, it should place the terms and conditions for such programmes before the Corporation for approval. If the nursing programme is approved by the Corporation, such accounts should not be included in the monthly declaration under WTPCG. Instead a separate packing credit guarantee will be issued for the account.

Claims. If recover efforts made by the bank fail to recover the entire debt within four mounts from the date of default, the bank can invoke the guarantee. Claim should be filed after four four months from the date of default but within 12 months from the date of expiry of guarantee. No fresh advance should be made to an exporter who has defaulted.

8.5.16 Whole Turnover Post-shipment Guarantee

The salient features of whole turnover post-shipment guarantee (WTPSG) are as under:

Advances covered. The bank should include all post-shipment advances, except letter of credit transactions. There is no restriction that the exporter should have obtained. I shipment policy of the Corporation. The bank has the option to cover L/C transactions under the guarantee. Advances against exports on consignment basis are eligible for cover under the scheme. Banks have the option to cover post-shipment advances granted to small-scale industries and public sector under takings.

Premium. Premium is payable on daily product basis instead of highest amount outstanding on any day during the month. The rate of premium is 5 paise per Rs. 100 per month if only non-L/C transactions are covered and 4 paise per Rs. 100 per month is L/C transactions are also covered.

Percentage of cover. The percentage of cover under the guarantee awould be 85 (instead of 75 under individual guarantee) in case of exporters who are ECGC policy holders and 60% in respect of and 65% respectively. Similarly, if L/C transactions are also included, the cover available is 90% and 65% respectively.

Discretion to sanction limits. Limits on individual exporters may be fixed by the bank itself up to the amount indicated by the Corporation in the guarantee. Sanction of limits requires prior approval of ECGC.

Countries under restricted cover. Banks are advised from time to time of the countries placed under restricted cover. Exporters holding ECGC policy are required to obtain ECGC"s prior approval for each shipment which should be checked by the bank

before granting advances in such cases. For non-policy holders, the bank should obtain ECGC"s concurrence for each shipment.

Extension of due date. Extension in the due date of payment of bills can be allowed by banks up to 180 days. Beyond this period, extension of time requires ECGC"s permission.

Term exports. WTPSG applies only to short-term exports. For advances in connection with deferred term exports, construction contracts or service, the bank has to obtain a separate guarantee. The same concessions as under WTPSG, including lower premium rate, will be extended for such guarantees also.

Claims. In case of default, a claim should be preferred by banks under the guarantee within one year from the due date of the advance or the extended due date as the case may be. Where the bill of the exporter is not paid by the buyer on the due date, bills drawn in other buyers can be advanced against till the bank prefers a claim with the Corporation. However, if the exporter is also unable to pay back to the bank the advance and a claim is preferred under WTPSG, no further advance should be given by the bank to the exporter. In case bank desires to nurse the account, it would do so in consultation with the Corporation.

8.6 INTERNATIONAL DEVELOPEMNT ASSOCIATION

The international Development Association (IDA) is an affiliate of the IBRD. It was established in 1960 to provide „soft loans" to economically sound projects which create „social capital" such as the construction of roads and bridges, slum clearance and urban development. The projects taken up by the IDA are such that fall under the category of" high development priority" due to their benefit on the development on the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects interest free and for longer periods. Therefore, IDA, is often refereed to as the „soft loan window" of World Bank.

8.6.1 Functions

The IDA extends assistance to high priority projects in the member-countries. The finance may be made available to the member-governments or to the private enterprise. Advances to private enterprises may be made without government guarantees. It also co-operates with other international institutions and member countries in providing financial and technical assistance to the less developed courtiers.

The financial assistance of the IDA has some special features:

The credit is interest free. Only a small service charge of 0.75% per annum is payable on the amount withdrawn and outstanding to cover administrative expenses.

Repayment period is long extending over 50 years. There is an initial moratorium for 10 years and the amount borrowed is repayable in the next 40 years.

IDA finances not only the foreign exchange component but also a part of the domestic cost.

The credit can also be repaid in the local currencies of borrowing countries. Thus the repayment of loan does not burden the balance of payments of the country.

8.6.2 Organization and Resources

All the members of the IBRD are eligible to become member of IDA. The Board of Governors and Executive Director of the IBRD are also ex-officio Bank Governors and Executive Directors of IDA. However, IDA is a separate entity distinct from the IBRD.

The members of the Association are grouped into two. Part I list consists of industrially developed countries whose subscriptions can be freely used or who are required to contribute 10% of their subscription in the form of other currencies and the rest in their own currencies. Contributions in the form of national currencies by these

countries are not to be used by the IDA for conversion to other currencies or for financing exports from these countries without the consent of the country concerned.

Evaluation

IDA has been a blessing for the developing countries to whom the credit from the IDA has largely gone. In keeping with the objectives, most of the assistance has gone to high development priority projects which could not get finance from other sources. India has immensely benefited from the IDA; it has been receiving a series of loans, almost continuously.

Multilateral Investment Guarantee Agency

The world Bank has established its another to be known as the Multilateral Investment Guarantee Agency (MIGA) aimed at encouraging foreign investment in developing countries by issuing guarantees against non-commercial risk.

MIGA provides guarantee to private investors against four types of non-commercial risks: (i) transfer of expropriation; (ii) risk of government repudiation of contractual commitments; and (iii) risk of armed conflicts and civil unrest.

One of the main reasons for promoting the new agency is stated to be the dramatic decline in capital flows to developing countries.

8.7 Industrial Credit and Investment Corporation of India (ICICI)

The Industrial Credit and Investment Corporation of India was set up in 1955 and its issued capital has been taken up by Indian Bank, insurance companies and others, certain individuals and corporations of the United States, the British eastern exchange banks and certain English and other Commonwealth insurance companies and other companies and the general public in India. The Corporation has been raising resources from within the country as well as from outside. It has obtained loans from the Government of India, the World Bank and from Reconstruction Loan Corporation of West Germany.

The aim of ICICI is to stimulate the promotion of new industries, to assist expansion and modernization of existing ones and to furnish technical and managerial aid so as to increase production and afford employment opportunities. The Corporation grants (a) long-term or medium-term loans, (both rupee loans and foreign currency loans); (b) participates in equity capital and in debentures, and underwrites new issue of shares and debentures, and (c) guarantees loans from other private investment sources. Apart from the above direct finance, ICICI provides financial services such as differed credit, leasing credit, installment sale, assets credit and venture capital

The total financial assistance sanctioned and disbursed by the Corporation between 1955 and 1995 amounted to Rs. 52,890 crores and Rs. 29,790 crores respectively, comprising foreign loans, rupees loans, guarantees and underwriting of and direct subscription to shares and debentures. The Corporation has so far assisted industries manufacturing paper, chemicals and pharmaceuticals, electrical equipment, textiles, sugar, metal ores, lime and cement works, glass manufacture, etc. In recent years, the Corporation has intensified its activities for assisting small-scale industries and industrial development of backward regions.

The Corporation has been playing a useful role in industrial finance. It assists industrial concerns with loans and guarantees for loans either in rupees or in any foreign currency. Besides, it underwrites ordinary and preference shares and debentures and it also subscribes directly to ordinary and preference share issues. A significant role played by the Corporation is the provision of foreign currency loans and advances to enable Indian Industrial concerns to secure essential capital goods from foreign countries.

ICICI commenced leasing operation in 1983 and provides leasing assistance for computerization, modernization/replacement, equipment for energy conservation, export orientation, pollution control, etc. The industries included under leasing are textiles, engineering, chemicals, fertilizers, cement, sugar, etc.

ICICI has set up a Merchant Banking Division which is working very creditably. During 1992-93 this division has completed 201 assignments and helped to raise Rs. 8,360 crores for its client, out of which Rs. 7,630 crores came from the capital market.

(a) Credit Rating information Service of India Ltd. (CRISIL), set up by ICICI in association with Unit Trust of India (UTI), provides credit rating services to the corporate sector;

(b) Technology Development and information Company of India Ltd. (TDICI), promoted by ICICI. Finances the transfer and up gradation of technology and provides technology information;

(c) Programs for the Advancement Commercial Technology (PACT), has been set up with a grant of US $ 10 million provided by USAID to assist market-oriented R&D activity jointly undertaken by Indian and U.S. companies; ICICI has been entrusted with the administration and management of PACT;

(d) Programme for Acceleration of Commercial Energy Research (PACER) is funded by USAID with a grant US $ 20 million to support selected research and technology development proposals in Indian energy sector; PACER was launched by ICICI

(e) During 1992-93 ICICI introduced two projects with the help of USAID, namely (i) Agricultural Commercialization and Enterprise project with a grant of $ 20 mi9llion, and (ii) Trade in Environmental sciences and Technologies Programme (TEST) with a grant of $ 25 million.

Growth of ICICI

There has been a remarkable significant increase in financial assistance redered by ICICI in recent years.

Table -1

Financial Assistance by ICICI ***[Rs .crores]***

	1980-81	1990-91	1994-95
Loans sanctioned	310	3,740	15,060
Loans disburse	180	1,970	6,880

Source: Economic Survey, 1995-96

In a matter of 15 years, a loan sanctioned by ICICI has increased from Rs. 310 crores to Rs. 15,060 crores and loans disbursed had increased from Rs. 180 crores to Rs.6, 880 crores.

8.8 INTERNATIONAL MONETARY SYSTEM

As efficient international monetary system is a necessary condition for the smooth functioning trade expansion of the international trade system. This chapter provides a brief account of the international of the international monetary system since early nineteenth century to this day.

The Pre-Breton Woods Period

Since the early nineteenth century until the post World War I period, which was regarded as the great age of internationalism, most of the major industrialized nations of the world and their trading partners operated, at least nominally, under a fixed exchange system called the gold standard. Under this system, each nation defined its currency in terms of gold. In 1900, for example, the dollar was equal to 1/20 of an ounce of gold and the pound to 5/20 of ounce (Hence £1 = $5). In addition, each nation agreed to convert its paper money into gold on demand, and there were no restrictions on the shipment of gold iron one country to another.

Under the gold standard, accounts between countries were settled, in theory, and to considerable degree in practice, by the exchange of gold. If a country imported goods more than those it exported, gold flowed out. As. under the gold standard, money supply depended on the monetary gold reserves, a reduction in this reserve due to a deficit in the Balance of Payments caused a contraction of money supply resulting in a decline in prices leading to an increase in demand for exports and decline of payments equilibrium. This, the gold standard provided for, in theory, automatic correction of a disequilibrium in the Balance of Payments through changes in the monetary gold reserves of nations. Balance of Payments situation could be improved also by other monetary measures like manipulation of the Bank Rate. For example, an increase in the bank rate

encouraged hot money movement and there-by helped the country to improve the Balance of Payments position.

Until the outbreak of the World War I, the gold Standard worked remarkably well and stability of exchange rate was maintained with so little conscious effort that it came to be regarded as natural. During this period nations were eager to abide by the golden rate of gold standard; expand credit when gold is coming in and contract credit when gold is going out. The gold standard, however, was shattered in the first weeks of the World War 1(1914-1918). Every belligerent country in Europe, and many in other continents, withdraw the privilege of conversion and prohibited the export and import of gold within a few days of declaring the war, and in course of the struggle most of the neutrals followed the suit. Inconvertible paper currencies became the order of the day.

After the war, and the hectic boom and slump that followed it, the international gold standard was restored in nearly every country of the world. As Crowther points out, two causes led to the restoration. The first was the natural wish to return to normality, the wish for 'back to pre-war'. Normality in currency arrangements meant the gold standard, and by most, if not all, of those in authority it was taken for granted that an international system of gold convertibility would follow the period of war-time inconvertibility, just as peace followed war. The second impelling force was the appalling chaos produced in Continental Europe by the wild inter-war inflation.

As Crowther points, in many ways the post-war gold standard went much further than the pre- war gold standard. It embraced, for example, many more countries. Many countries of Europe which before the War had not belonged to the charmed circle of the gold standard, stabilized their currencies in terms of gold, and virtually all of the South American republics, most of whom had inconvertible currencies in 1914, followed the fashion. By the middle of 1929, almost the only countries that were not on the gold standard were China, Spain and Mexico. Not all of these countries adopted the full gold standard or even the gold bullion standard, but the gold exchange standard was extensively employed.

However, within little more than a decade from the beginning of its post-war reincarnation, the gold standard had once more been abandoned by the great majority of the nations. Gold standard was one of the first casualties of the Great Depression (1929-33) which engulfed the entire world Great Britain suspended gold standard in 1931 and one by one other countries followed suit and by 1937 there was not a single country on the gold standard and none showed any desire to revive it.

The break-down of the gold standard in the 1930s was followed by the era of inconvertible currencies. Some leading countries attempted to stabilize exchange rate by establishing exchange equalisation/stabilisation funds and agreements. However, with the outbreak of the World War II (1939-45), nations began to impose far-reaching systems of exchange control and the monetary agreements became inoperative.

The Breton Woods System

During the World War II, eminent economics and civil servants in the Allied Nations were seriously planning to evolve a purposeful international economic system in the post-war period. President Roosevelt of America, in fact, gave a high priority to planning for the peace, a fording every themselves to this cause. The United Nations Monetary and Financial Conference held at Bretton Woods, USA, in July 1944 while the war was still going on and in which 44 nations participated, proposed the establishment of (i) The International Monetary Fund (IMF) mainly to achieve exchange rate stability and to help member countries to finance the short-term Balance of Payments deficits,, (ii) The International Bank for Reconstruction and Development (IBRD), today more popularly known as the World Bank, to assist the post-war reconstruction and development of the member countries, and (iii) an International Trade Organization (ITO) to be the local point of cooperation in trade matters. The proposal to establish the ITO did not materialize; but later the GATT was formed. The IMF and the IBRD, however, tool birth. Though the negotiations at Bretton Woods ended in 1944, the IMF began its operations only in 1947.

Check Your Progress

6 The IMF began its operations _____.

The international monetary system introduced by the Bretton Woods rested on two pillars; the maintenance of stable exchange rates and a multilateral credit mechanism institutionalized in the IMF and supervised by it.

The international monetary system that existed from 1947 to 1971 is generally known as the par value system or the pegged exchange rate system. Under this system, each member country of IMF was required to define the value of its currency in terms of gold or the US dollar and to m maintain (to peg) the market value of .its currency within ±1 per cent of the defined (par) value. The value of the US dollar was set at 1/35 of an ounce of gold, arid the United States promise that all US dollars in the hands of central banks would be redeemed in gold upon demand at the fixed price of $35 per ounce. Every other nation then defined its currency in terms of the dollar and/or gold.

At the end of the Second World War, the United States held over 74 per cent of the world's monetary gold stock and accounted for about half of the world's peal GNP. As Leonard Gomes observes, given the financial dominance of the United States, it was inevitable that other countries came to "regard the US dollar as international money. They used the dollar as an 'intervention currency' to stabilize exchange rates in the market and accumulated it in official reserves. Countries were further prompted in this direction by the failure of gold, a key source of reserves in the Bretton Woods System, to provide a steady and sufficient increase in international liquidity over time. The increase in central bank's demand for gold was greater than the increase in monetary gold stocks resulting from new production because of its artificially low price; the demand could only be met by; drawing on US supplies. In the early post-war years of reconstruction the European countries were happy to accumulate dollar balances whenever they could by running balance of payments surpluses with the United States, These finds provided them with access to American commodity and capital markets. The dollar was not merely as good as, gold, it was better than gold because dollars (as' reserves) earned interest while, gold did not.

The designers of the par value system realized that the exchange rate between two currencies could not be held constant for ever, but they hoped that changes would be

infrequent and would be made for valid reasons under controlled circumstances. The provisions of the Agreement relating to changes in par values can be summarized as follows:

1. A member shall not propose a change except "to, correct a fundamental disequilibrium", and it shall act only after consolation with the Fund.
2. The Fund will not object to changes not exceeding 10 per cent of initial par value.
3. If a change is proposed exceeding 10 per cent, but hot exceeding 20 percent of the initial par value, the Fund may agree or object, but most declare its attitude within 72 hours.
4. If the proposed change is larger than 20 per cent the Fund may .concur or object without limit of time.
5. The Fund must agree „if it is satisfied that the change is necessary to correct a fundamental disequilibrium". And it is, further laid down that in deciding what is a fundamental disequilibrium, the Fund. May not take objection to the „domestic and social or political policies of the member proposing the change'-that is, it may not say that wages have been raised too quickly and ought to be reduced as ah alternative to the devaluation of the currency.

The IMF is also meant to provide credit facilities to member countries suffering from payments problems. The credit facilities a member country can avail of normally depends on its quota, i.e., the member's contribution to the Fund which is determined on the basis of the nation's income, reserve holdings, imports, ratio of exports to income and the variability of imports. Prior to the 1976 changes, new members were required to the pay part of their quota, normally 25 per cent, in gold or American dollars and the rest in the member's own currency. Now a new member pays part of its quota in foreign currency and the rest in its own currency. The Fund also extends certain permanent, temporary, special facilities to its members like the compensatory financing facility, the buffer stock financing facility and the oil facility.

An important contribution made by the IMF to increase international liquidity is the creation of Special Drawing Rights-SDRs. The SDR is an international reserve asset created by the Fund, taking into account the global need to supplement existing

reserve assets. SDRs in existence today total SDRs 2.3 billion, about 6 per cent of present international reserves, excluding gold (as on June 30, 1982 SDR 1 = $1.09). Allocation of SDRs was made to member countries that were participating in this facility in proportion to their quotas.

Break-down of the Bretton Woods System and the emergence of Managed Floating

Let us now come back to the par value system. Despite severe strains in its later years, it lasted until 1971. The stabilization process under this system required reserve assets, just as it did under the gold system. The difference was that nations kept their reserves not only in gold but also in dollars. Expansion of trade requires an increase in international liquidity. Major part of the gold and dollar, the international reserves, being in the USA, growth could only from an outflow of gold and dollar from the USA.

In the early period, supply of dollar to outside the USA came from the Marshall Plan and other American aid programmes, contributions to the World Bank etc., multinational investments; American Balance of Payments in the 1950s was generally welcomed as they increase the international liquidity and it appeared that the Bretton Woods System, by permitting the expansion of world monetary reserves at a much quicker rate than a system restricted by the supply of gold, it solved one of the major problems of the gold standard. But the key factor in guaranteeing the workability of the system was the acceptability of the dollar. If anything were to happen that would shake the world confidence in the ability or desire of the United States to continue exchanging dollars for gold, the system might very well collapse. And the Bretton Woods System did collapse in 1971 as, because of the huge accumulation of dollars abroad, the USA could neither command the world confidence in her ability and willingness to exchange dollar for gold at the fixed rate, nor could afford to undertake the conversion of dollar into gold if all the foreign dollar holdings were presented for such exchange.

It is the burgeoning Balance of Payments deficits of the United States since the late 1950s that led to such a situation. The United States moved from a Balance of Payments surplus of $4 billion in 1947 to a deficit of over $29 billion in 1971 and the dollar shortage of the 1950s turned into the dollar glut of the 1960s and early 1970s. The

US official gold stock dropped from about $ 25 billion in 1949 to around $ 10 billion by 1971. However, only a part of the US deficit was financed by export of gold. As dollar was regarded as an international reserve, the US deficit became a significant means of expanding the total supply of the international liquidity.

However, the depletion of the US gold reserves and the huge accumulation of her liquid liabilities (dollars and dollar convertible assets) held by foreigners perpetuated a "crisis of confidence". By 1971, these liabilities had risen to about $ 68 billion; in 1971 the Central Bank of Germany alone held enough dollars to exhaust the entire gold stock of the USA at $35 an ounce.

Foreign exchange markets became hectic in early 1971, and central banks with the strongest currencies had to buy massive amounts of dollars in order to maintain exchange rates at the official par value (+1 per cent). They closed foreign exchange markets for brief periods, allowed currencies to float temporarily, imposed exchange controls and even charged negative rates of interest of foreign-owned deposits-all in a vain effort to stem the tide. While the foreign central banks became increasingly reluctant to continue the stabilization procedure, speculators and multinational corporations became very eager to unload dollars (which, they felt, would soon be worthless) and to acquire other currencies instead. Thus, the international monetary system was confronted with two interrelated problems. On the one hand, the traditional buyers of these dollars-the foreign central banks-were no longer willing to purchase. The eventual outcome was the collapse of the par value system. And the IMF's par value system, officially ended on August 15, 1971, when President Nixon withdrew United States' commitment to buy and sell gold at $ 35 per ounce, thus abrogating the IMF agreement this amounted to severing the link between gold and the international value of dollar. Along with the suspension of the gold convertibility of dollar, President Nixon also imposed a surcharge of 10 per cent on dutiable imports to the USA.

President Nixon justified the suspension of convertibility as necessary to "defend the dollar against speculators" who "have been waging all-out war on the

American dollars". But, actually, it was designed to compel foreign governments to raise the value of their currencies against the dollar.

However, the European and Japanese governments firmly resisted any change in the par values, of their currencies, fearing the harmful consequences of revaluation on their exports and domestic economic situations. They held the view that if the US dollar was overvalued, the way out should be a unilateral devaluation of the dollar.

The immediate response to the US action of the suspension of dollar convertibility was a closing of foreign exchange markets in European and Japan. When they reopened, all of the major currencies were left to „float vis-a-vis the dollar with the exception of French franc. Although France refused to float its currency for commercial transactions, it permitted a floating rate financial rate for financial transactions.

The floating of currencies was, however, none "as central banks intervened in the market to prevent a full appreciation. The European and Japanese governments were reluctant to let their countries float freely because they hoped to persuade the United States to devalue the dollar.

The urgent need to put an end to the fluid situation was felt by the major countries and international monetary negotiations were undertaken within the framework of the Group of Ten, which included Finance Ministers of ten leading IMF trading nations. The first meeting of the Group in London and the second meeting in Rome (both in September 1971) failed to resolve the crisis. However, some encouraging developments came out of its third meeting, which started on November 30, in Rome. Finally, the meeting of the Group of Ten on December 17-18, at the Smithsonian institution in Washington brought about an agreement for the realignment of exchange rates to correct the prior overvaluation of the dollar.

Following the Smithsonian Agreement, the United States increased the dollar price of gold by 8.57 per cent (from $ 35 an ounce to $ 38 an ounce) and the Yen and major European currencies appreciated relative to dollar-the Yen 17 per cent, the Mark

by 14 per cent and most other European currencies by somewhat under 10 per cent. Over all, the dollar was depreciated by an average of approximately 12 per cent.

Under the Smithsonian Agreement, currencies were allowed to fluctuate within a wider 2.5 per cent range on either side of the newly-fixed rates called the central rates. Like the Bretton Woods System, the Smithsonian Agreement also required central bank stabilization efforts, but it allowed more fluctuation of rates (2.5 per cent as against 1 per cent).

The Smithsonian Agreement, however, did not last long. Renewed speculative activity in 1972 and early 1973 forced most major countries to abandon foxed rates. In February 1973, President Nixon announced a 10 per cent devaluation of the dollar from $ 38 to $ 42.2 an ounce.

The Smithsonian Agreement thus, lasted only for fourteen months. The collapse of the Smithsonian Agreement resulted in a floating exchange rate system. Monetary authorities have not, however, been allowing their currency values to be determined solely by demand and supply, but have been intervening from time to time to keep the exchange rates within desired limits. This is known as the managed float. The managed float provides the advantages of floating exchange rates and avoided the disadvantages of sharply fluctuating rates.

The Jamaica Agreement of January 1976 formally ratified the floating exchange rate system. The Agreement recognized that although exchange rates should reflect the basic forces of demand and supply, governments have the right to maintain their own stabilization policies and to intervene in foreign exchange market. All governments, however, should pursue the common goals of international stability and growth. It also eliminated the official price of gold. The IMF sold one-sixth of its gold and used the proceeds to help the LDCs. The IMF has no further obligation to use gold.

Since 1972, the world may be said to be on flexible exchange rates, although the peggers far outnumber the floaters. "Despite the large number of countries that peg their currencies, in-trade- weighted terms, the current system is better classified as

floating because most of the largest traders maintain more flexible forms of exchange agreements. In fact, in trade-weighted terms, about two- thirds to four-fifths of world trade is conducted at floating rates."

During the period of flexible rates since 1973, there has been a trend away from pegged exchange arrangements, and within these, form single currency to composite pegs (with former US dollar peggers accounting for the bulk of the latter shift). Most developing countries have been pegging their currencies while the industrial countries by and large, have been on the flexible system (including the eight European countries that operate within the cooperative exchange arrangements of the European Monetary System-EMS). However, as stated in the preceding paragraph, the flexible currencies transact .the major chunk of the world trade and hence the world is regarded to be flexible exchange .rate system, by and large. The floating of currencies, however, is not completely free or clean but dirty (i.e:, it is subject to some government intervention).

As Paul Samuelson remarks, "floating exchange rates remove gold standard discipline on nominal or money price-and-wage levels. Nothing can remove the irreducible constraints of system's real productivity levels. Floating is not a panacea. It is at best an opportunity.

8.9 SPECIAL DRAWING RIGHTS

During the late sixties the growth in world resources did not keep pace with the growth in international trade. During 1963-68, the monetary reserves in the form of gold and US dollars increased by about 16% while for the same period the growth in the international trade was of the order of 70%. The slackness in the growth of resources was mainly due to dependence on the accretion of gold to monetary reserves. It was foreboding that the slow growth of monetary reserve would result in hampering the growth .of-monetary reserve would result in hampering the growth of international trade and in serious balance of payments difficulties to many countries. The need to increase he international liquidity, i.e., resources for settlement of international debts, was felt and after much thought on the subject, it resulted in the introduction of Special Drawing Rights (SDRs) in 1970.

Nature of SDRs

SDRs are entitlements granted to member-countries enabling them to draw from the IMF apart from their quotas. The arrangement is similar to a bank granting credit limit to its customer. When SDRs are allocated the country's Special Drawing Account with the IMF is created with amount of the allotment. When the country experiences need for foreign exchange it can sell SDRs to another country and get foreign exchange. Thus, if India is in need of foreign exchange and UK agrees to meet this need to the extent of SDR 100 million the agreement can be made as follows.-India would inform IMF that it is selling SDR 100 million to UK. IMF would debit this amount in the India's Special Drawing Account and credit the same to the account of UK. India would receive from UK pound-sterling or any other currency, as agreed between them.

As can be observed from the above, SDR is not a currency and has no backing of any security. Nor is the IMF liable on the SDRs allocated. It is merely an asset created out of book entries. It is an independent reserve asset, supplementing other reserve assets, the volume of which could be increased or decreased according to the reserve needs of the international community. The real strength of the SDR lies in the undertaking by the member-countries to abide by the Articles of Agreement of the IMF and exchange SDRs for currencies. Every member participating in the SDR scheme is required to accept up to 200% of its allocation of the SDRs when offered by other countries and exchange with currency of its own or other countries. On its own, a member can hold SDRs above this statutory obligation.

Allocation

Allocation of SDRs is made to member-countries in proportion to their quotas. The decision to allocate SDRs is taken periodically by the Board of Governors taking into account the requirements of international liquidity. A majority of 85% of the voting power is required for decisions involving allocation or canceling of SDRs. Starting from 1970, when SDRs were first allocated, the quantum of SDRs allocated has increased over the period and as at the end of April 1990 the total amount of SDRs allocated stood at SDR 21.4 billion.

Valuation and Interest

It may be remembered that SDR was introduced before the dollar crisis of August 1971. Keeping with the monetary environment prevalent at the time of its introduction, initially the value of one SDR was equal to a specific quantity of gold (which was equal to the value of 1 US dollar) and was provided with an "absolute gold value guarantee. That is why SDRs were popularly known as 'Paper Gold'. After the dollar debacle when the major currencies began to float, the link the SDR was linked to a basket of 16 principal currencies. In 1981, the composition of the basket was simplified by replacing the 16 currencies with those of the 5 major trading nations. The currencies and the weight age given in the valuation revised with effect from. 1.1.1991 is: US Dollar (40%), Deutsche Marks (21%), Japanese Yen (17%), French Franc (11%), and Pound-sterling (11%). The IMF values SDRs in terms of the composition of the basket every day and announces the value of SDR in terms of US dollars.

When a member-country utilizes SDRs, interest at 100% of the weighted average of the short- term rates prevailing in the above five countries is charged. The interest rate is revised every quarter. Similarly, for those with additional holdings of SDRs, than the allotment, interest at the same rate is paid.

Utilization

For the sake of convenience, with the establishment of SDRs, the accounts of the IMF are kept in two sets, the General Account and Special Drawing Account. The ordinary transactions of the IMF relating to quota subscriptions, repurchases and payment of charges are conducted through the General Account. Transactions related to SDRs are routed through the Special Drawing Account.

Originally SDRs were to be used only for meeting balance of payments deficits. It could be used only in any of the three ways prescribed. The first was transactions with designation. That is, when a country experiences a balance of payments deficit and requires other currencies it had to apply to the IMF. On receipt of such applications, the !MF would designate another country with strong balance of payments and reserve position to accept SDRs from the deficit country and pay in exchange some

currency. As already noted, participants were obliged to accept SDRs in this way as long as their holdings were less than three times their total allocations.

The second was the sales of SDRs for currency by arrangement with another participant, i.e., without designation by the IMF. Such transactions by agreement were permitted only if the user of SDRs was redeeming balances of his own currency held by the other participant or if the Fund authorized the particular transaction or had made a general authorization of that particular type of transaction. Generally, the country selling SDRs was subject to the requirement of a balance of payments deficit.

Thirdly, SDRs could be used in transactions with the Fund, For instance, in payment to charges to the Fund.

Due to later developments and as a consequence of endeavors to make SDRs an international unit of account, their use has been liberalized. Now SDRs can be used directly among the members without the approval of the IMF and without restriction relating to the balance of payments requirements. A country may swap SDRs with another country to acquire a currency it desires. SDRs can also be used to make and repay loans among governments and to serve as security for the performance of financial obligations. Besides, the IMF has authorized certain international institutions such as the Bank for International Settlements, International Bank for Reconstruction and Development, to hold SDRs. currently such institutional holder"s number 16.

SDR has gained importance both as a reserve/asset and as means of settlement of international transactions. While SDRs cannot be transferred among private individuals, private parties do sometimes use the SDR as a standard of value. Few international banks accept time deposits designated in SDR. Fifteen member countries have pegged their currencies to SDR.

8.10 DEVALUATION

Devaluation, an official reduction in the value of the domestic currency in terms of foreign currencies, or exchange rate adjustments, or exchange rate adjustments, is a common thing. For example, between 1985-87 the US engineered a 50 per cent fait in

the external value of dollar through the Group of Seven. Many of India's other trade partners have also made substantial exchange rate adjustments over the past few years. Over the period end December 1980 to end December 1989, China depreciated the currency by 68 percent and Indonesia by 65 per cent while India depreciated by only 54 per cent against the US dollar, whereas increase in consumer prices in China and Indonesia were lower (at 100 per cent and 111 per cent respectively) against India's 114 per cent over the same period.

Devaluation is resorted to help correct the balance of payments disequilibrium by increasing exports and decreasing imports. To illustrate, let us take the example of the devaluation of Indian rupee in 1966. Just before the devaluation of the Rupee with effect from 6-6-1966, the exchange rate was $ 1 = Rs. 4.76. The devaluation of the Rupee by 36.5 per cent changed the exchange rate to $1 = Rs.7.50- Before devaluation, the price of an imported commodity which cost $ 1 abroad Rs. 4.76 (assuming costless free trade). But after devaluation, the same commodity which cost $ 1 abroad would cost Rs.7.50 when imported because of the change in the exchange rate. Thus, devaluation makes foreign goods costlier in terms of domestic currency and this is supposed to discourage imports. On the other hand, devaluation makes exports (from the country that has devalued the currency) cheaper in foreign markets. Taking the above example, before devaluation, a commodity which cost Rs. 4.76 in India was sold abroad at $ 1 (assuming costless free trade), but after devaluation the landed cost abroad of the same commodity was only $ 0.64. This comparative cheapness of the Indian goods in the foreign markets was expected to stimulate demand for Indian exports.

It may appear that devaluation can help solve the problem of trade deficit by stimulating exports and curtailing imports. But in actual practice, the effect of devaluation depends on a number of intricate and, often, interdependent factors. Depending on tense factors the net effect of devaluation may be favorable. If factors are, by and large unfavorable, exports may not increase sufficiently enough to improve the trade position or the high cost of imports and certain other developments resulting from devaluation may cause inflation and nullify the, initial effect of devaluation on export prices.

A basic assumption related to devaluation is that the demand for the country's exports and imports is price elastic, i.e., a fall in exports prices will substantially increase the demand for exports and an increase in the prices of imports will significantly reduce imports. However, these things need not necessarily happen.

The demand for many exports of the developing countries, like the primary commodities, is regarded as relatively price inelastic, that is, a fall in the price will not significantly increase the demand. On the other hand, the demand for money of the imports of the developing countries, like essential consumer goods, technology etc., is also relatively price inelastic, i.e., an increase in the import prices will not considerably reduce the imports.

It should be noted that devaluation may lead to a fall in the unit value of exports and hence the total earning will increase only if the quantum of exports increase more than the rate of fall in the unit value of exports following the devaluation. If the quantum of exports does not increase at least to the extent of the rate of fall in the unit value of exports following the devaluation. If the quantum of exports does not increase at least to the extent of the rate of fall in the unit value of exports, there will be a fall in the total export earnings. However, as trade balance is a function of both exports and imports, we have to consider the effect of devaluation on both exports and imports, in other words, devaluation will improve a country's trade balance only if the sum of elasticity"s of demand for exports and of its demand for imports is greater than one. This is described in economies as the Marshall-Lerner condition.

If the demand for imports is inelastic, not only that devaluation will not reduce the import bill but also will lead to price rise in the domestic economy because of the increased cost of the imported consumer goods, capital goods, intermediate goods, raw materials, etc. This increase in domestic prices will soon wipe off the price advantage in respect of exports brought about by devaluation. If the exports have content, as is true in many cases, the problem is further accentuated. Thus, the whole situation could again deteriorate to make the trade balance very adverse.

Even if there is good demand for a country's exports, exportable surplus is an important determinant of export earnings. Given the level of domestic absorption, exportable surplus depends on the level of domestic output which is affected by such factors as supply of inputs like raw materials and power, climatic conditions which affect agricultural production etc. While adverse factors will reduce the exportable surplus of some commodities, short supply will necessitate larger imports of some other commodities.

An important condition necessary for the success of devaluation is that other countries should not retaliate or should not take measures which discourage our exports to them. For example, if an importing country enhances import duties, the prices of our exports by reducing prices by devaluation and in the absence of sufficient increase in the quantum of exports we might end up with a lower export earning due to the fall in the unit value of exports. Further, competitors may react by depreciating their currencies.

There are, thus, a host of factors which determine the success of devaluation in improving the foreign trade balance. Against this background, let us have a look at the factors which tend to limit the success of devaluation in India.

Devaluation will stir up domestic prices because we are very import dependent. Many of our vital imports, being essential items, are price inelastic in demand. Petroleum oil and lubricants (POL) account for a large share of our of our total import bill. In the event of devaluation, the increase in the price of imported oil will have cascading effect on domestic prices. Chemicals are also important imports and their imports will not be considerably affected by price. We spent a considerable amount on import of capital goods. There are also a number of indispensable consumer goods, raw materials and intermediate goods imports. The demand for many foreign goods which satisfy „conspicuous" consumption is relatively price inelastic.

Thus, devaluation is unlikely to achieve considerable import savings. On the other hand, it will raise domestic prices because of the high cost of capital goods, oil, raw materials, intermediate goods, etc. It may also encourage smuggling. Devaluation will increase the output prices of industries using imported inputs. This point is clearly

demonstrated by the increase in the prices of automobiles manufactured with Japanese collaboration following the appreciation of the yen. A devaluation of the rupee will have similar effect on the output prices of industries using imported inputs.

Many Indian exports embody imported inputs. Therefore, devaluation will have direct effect on export prices, apart from the effect of general increase in prices in the economy. Therefore, thee initial price advantage of exports imparted by in valuation will soon vanish and will usher in a further high cost domestic economy.

Agro-based products account for a significant share of our total exports. Adverse weather and climatic conditions may affect their exportable surplus and necessitate increased import of certain agricultural based products. This unfortunate situation occurred in the year following the devaluation of 1966. Even if there will be good foreign demand for certain industrial products our ability to generate sufficient exportable surplus is constrained by inadequacy of the productive apparatus and other supply bottlenecks.

8.10.1 Rupee Devaluation of July 1991

Having discussed the conditions necessary for the success of devaluation and the possible limitations and problems of devaluation in general, let us now consider the devaluation of the Rupee in July 1991 which was one of the trade promotion measures taken in the context of persistent balance of payments deficit and the consequent foreign exchange crisis.

While many criticize the government for not having effected the devaluation in one stoke, C.Rangarajan, former Governor of the Reserve Bank of India and a member of the Planning Commission, justifies the adjustment made in two stages. Basically, the first adjustment enabled to test the waters. After the second adjustment, it was made clear that there would be no further change. He also points out that 18-20 per cent devaluation was completely appropriate under the circumstances.

Rengarajan also answers the questions: why such a large exchange rate adjustment over a short span of time? Couldn't we continue to make small changes in

exchange rate as we had been doing? The answer lies in the role of expectations. In certain circumstance's it is better to make a significant adjustment and dampen anticipations so as to attract remittances and capital inflows. Even in these days of fluctuating exchange rates many countries have affected large, discrete devaluations in the recent past.

The July 1991 devaluation should not be viewed in isolation. It should be seen as an important item of a package of measures introduced to reform the trade regime which is linked to the general economic policy reform introduced in the country. The evaluation of the devaluation should be made in this context.

Other important measures in the trade promotion include abolition of the Cash Compensatory Support (CCS) and modification of the REP scheme.

The abolition of export subsidy, namely, CCS was a much needed measure for two important reasons. Firstly, it was an important contributor to the surging fiscal deficit in India. If the CCS were not abolished, in, 1991-92 it would have amounted to an estimated Rs. 3,000 crore or more.

Secondly, the CCS, being an export subsidy, was strongly opposed by forums like GATT and retaliated by importing countries. Further, looking at the CCS which the Indian exporters were enjoying, importers of Indian goods often tried to bargain down the prices.

In addition to the above reasons, the administrative problems like the delays in dispersing the CCS, fixation of appropriate CCS rates etc. called for its replacement by a better alternative.

The devaluation and the modified Rep scheme, which is now called the Exim scrip, more than compensate the exporters for the loss of the CCS while solving the problems created by the CCS to the nation and exporters. Further, all exporters benefit out of the new regime. More particularly" export with least intensity benefit the most.

In the preceding section we have seen that the success of devaluation in increasing exports depends on a number of factors. One of these factors is the elasticity of

demand for exports. According to an econometric estimation, the elasticity of exports with respect to the real effective exchange rate (PEER) is 0.66, i.e., for a one percentage point depreciation of the REER, export volume would increase by 0.66 of one per cent. Exports of manufactured goods are even more priced- sensitive. It needs to be cautioned that the quantitative estimates may not reflect the exact picture as they are not able to incorporate several relevant factors influencing the exports. These estimates however are indicative. Further, the change in the composition of India's exports makes the situation in the 1990s different from what it was at the time of the devaluation in the 1966.

The compositions of India"s exports have undergone significant changes since the mid 1960s and manufactured exports today constitute 75 per cent of total exports.

It should, however, be noted that exports of several commodities continue to suffer because of supply constraints for which devaluation is no solution. There is no alternative to increases in their supply. The industrial policy liberalizations including the policy towards foreign capital and technology provide a much better environment for supply expansion when compared at the situation at the time of the 1966 Rupee devaluation.

It has been reported that export of certain commodities have been boosted following the increased export profitability due to devaluation and modification of the Rep scheme. Further, export of certain commodities which was not profitable earlier has become profitable consequent to devaluation.

Although devaluation makes imports costlier, imports of essential items cannot be contained unless the domestic production increases to bridge and demand supply gap. Thus, on the import side also devaluation is no alternative to increase in domestic production.

Devaluation can encourage import substitution. Several such cases have been reported. For example, in the two-wheeler industry where there is fierce competition among producers, one company has reduced its imported capital goods to half by substituting them with local machine tools. The difference between the original planned imports of capital goods and what is now proposed runs to tens of crores of rupees in the

case of this particular project. Another company had planned the import of a major piece of equipment costing about a million dollars. By the time the company got CG licence the rupee costs had gone up to such a level that the company decided to fabricate the equipment itself. It has done so successfully and is now thinking in terms of exporting it. Such examples of import substitution arising from the exchange rate policy could be multiplied.

It has been pointed out that despite notions to the contrary our imports are also sensitive to relative changes in price changes. A recent study shows that the price elasticties are greater than one for manufactured goods and machinery and transport equipment .which amounted to an estimated 50 per cent of total imports in 1989-90. This does not mean that consumer demand for other imports is not responsive to prices. In many cases higher import process are not passed through to consumers because of a proportion of our imports such as defense imports and bulk imports are insulated from price factors. Consequently the impact of the changes in the value of the currency is not fully reflected in imports.

Devaluation, obviously, increases prices of imported goods and products with import content. The increase in the price level. It has been reported that devaluation will increase the cost of various multilateral and bilateral aided power projects by about Rs. 30,000 crore and as a result against the on going Rs. 2.5 to 3 crore per mega watt cost for thermal projects, the effect of the depreciation of the rupee will push the per watt cost to over Rs. 3.5 crore.

Unless the government takes effective measures to contain inflation, the favorable price effects of devaluation on exports will be soon wiped out, particularly in respect of products with import content.

An important question in this context is can the government control the prices? The answer is 'Yes', if appropriate measures are taken. Apart from the general measures of price control there are certain specific measures that could be taken to prevent a price rise due to devaluation. Devaluation does not increase the foreign exchange cost of imports. Hence the government can hold the price of essential items like

petroleum products. But the tragedy is that to increase the revenue flow to the exchequer the government increases the administered prices. The imported price of items like capital goods can be prevented from rising due to devaluation if the government lowers the tariff wall. But here also revenue consideration often overrides other consideration.

If the government does not hold the price line by these and other measures, the benefits of devaluation will be short-lived.

Further, to improve the export performance considerably, we should move ahead from international trading to international marketing.

8.11 CENTRAL BANK

Introduction

Central bank is an important financial institution in every sovereign independent state in modern times. It is the apex of economy's banking system. It plays an active role in implementing government's economic policy, in the country. According to Will Rogers, central bank occupies the coveted position of being one of the three great inventions that have taken place since the beginning of the times, the other two being the fire and the wheel. Although some people may seriously doubt if central bank could belong to such an exalted company, but they all agree-that central bank is one of the most useful economic institutions which has been developed to help society manage its collective financial affairs. Today, central bank is the central arch of the monetary and fiscal framework in every country of the world and its activities are essential for the proper functioning of the economy and indispensable for the fiscal operations of the government. Although some central banks were established more than two centuries ago, central, banking is mostly a recent development being essentially a product of the nineteenth century. Although the Riksbank in Sweden was established in 1668, the Bank of England was established only in 1694. It was the first to function as a true central bank in 1844. Central banking originated in England almost by chance bank found it convenient to settle their clearing balances by cheques on the Bank 0f England. The history of the Bank of England represents the history of the evolution of the principles arid techniques of central banking. The Bank of France which was organized in 1800 was

closely connected with the state ever since its establishment. The Reich bank in Germany was established in 1876 after the formation of the Empire. The Bank of Netherlands was founded in 1814 on the ruins of the old Bank of Austria-Hungary in 1877, was established in 1817 to restore order in the national monetary system which had deteriorated, due to over-issue of paper currency. The Bank of Norway, the National Bank of Denmark, the National Bank of Belgium, and the Bank Spain were established in 1817, 1818, 1850 and 1856 respectively. The Bank of Russia was established in 1860 to consolidate money circulation and to float debt for the Russian Empire. The Bank of Japan was established in 1882 to restore order in the currency system of the country. The Bank of Italy was established in 1893 while the Swiss National Bank was established at the turn of the century in 1907. In the nineteenth central banks were also established in Portugal, Rumania, Bulgaria, Syria, Turkey, Java, Egypt and Algeria. These banks possessed the monopoly of note issue. Thus, nineteenth century was a century par excellence of the establishment of central banks in many countries of the world, particularly in Europe where almost every country had established a central bank empowered to issue notes with special privileges and powers. In due course of time, these banks became bankers and advisers to their respective governments.

Although by the end of the nineteenth century almost ever/country in Europe had a central bank, the concept of the central bank was not, of course, too clearly articulated or understood before the turn of the country, and some of these banks were not always fully aware of their special functions and responsibilities. For example, the Swedish Riksbank and the Bank of Italy probably did not become "real" central banks until about the turn of the century. Moreover, the countries of the Orient u barring a few like Japan, Java and Egypt-and of the New World did not have central banks. In 1900 there was no central bank in the Western Hemisphere. The Federal Reserve System in America was established in 1913 while the Bank of Canada was established in 1934. Important countries of East such as India and China had no central banks. Thus, in the twentieth century the work of establishing the central bank continued. In the post-war period, characterized by strong nationalism and state control over economic life of the community, were witnessed extensive additions to the list of central banks and a general enlargement of the central banks was provided by the international Financial Conference

held at Brussels in1920. This Conference resolved that oall those countries which had not yet established a central bank should proceed to do so as soon as possible, not only with a view to facilitation the restoration and maintenance of stability in their monetary and banking systems but also in the interest of world cooperation."[1]

[1 M.H.De Kock, Central Banking, 3rd edition. Reprinted 1956, p. 19.]

The period of more than three decades immediately following the Conference resolution saw a rapid growth of central banks in different countries of the world. From 1921 to 1937, barring 1929 and 1930, every year one or more bank was added to the list of central banks. Just as the Brussels Conference of 1920 accelerated the pace of growth of the central banks after World War I, in the same Way the IMF further facilitated the development of central banks in the new Afto-Asian and Latin American countries. The governments of these countries found that the central bank could deal more effectively with the IMF and other related matters relating to foreign exchange. Today every independent country has a central bank. The number of these central banks now stands well over 150 and of these more than half have been established after 1940.

What is a Central Bank?

A modern central bank performs **so** many functions of different nature that it is difficult to give any brief yet accurate definition of a central bank. Any definition of a central bank is derived from" its functions and these functions have varied from time to time country to country. Like the topsides, the function of central banks has grown over time making it more difficult to give any brief and unchanging definition of a central bank. Nevertheless, a central bank may be defined as that central monetary institution- which is charged with performing the duties of bankers' bank, fiscal agent for the government and managing the monetary system of the country. Furthermore, it must also be stated that, barring rare exceptions, a central bank should not conduct commercial banking business. Economists have defined central bank differently, emphasis its one function or the other. According to Vera Smith, "the primary definition of central banking is a banking .system in which a single bank has either complete or a residuary monopoly of note issue".[2] In Shaw's opinion, the central bank is a bank which controls credit.

According to Hawtrey, central bank is the lender of the last resort. According to the Statutes of the Bank for International Settlements, a central bank is "the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country." According to the Kisch and Elkin, a central bank is a bank whose essential duty is to maintain stability of the monetary standard. In short, while Vera mith's definition stressed the note issue function of central bank, definitions of Shaw, Hawtrey, the Bank for International Settlements, and Kisch and El kith emphasize the credit control, lender of the last resort, regulations of currency and credit, and maintenance of stability of the value of the money unit functions of the central bank.

[2 Vera Smith, Rationale of Central Banking, p. 148.]

M.H. De. KocKs concept of central bank is superior to that of others as it is more inclusive. His long definition of central bank includes many of the important functions performed by the central bank. However, his definition lacks brevity which is an essential quality of any definition. According to De Kock, a central bank Fs "a bank which constitutes the apex of the monetary and banking structure of its country and which perform^ as'-best as it can in the-national economic interest, the following functions

The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a partial monopoly theory.

The performance of general banking and agency services for the State.

The custody of the cash reserves of the commercial banks.

The custody and management of the nation"s reserves of international currency.

The granting of accommodation, in the form discounts or colletral advances, to commercial banks, bill brokers and dealers, or other financial institutions, and the general acceptance of the responsibility of lender of the last resort.

The settlement of clearance balances between the banks; and

The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary police adopted by the State.

A further requisite of real central bank is that is should not. To any great extent, perform such banking transaction as accepting deposits from the general public and accommodation regular commercial customers with discounts or advances. It is now almost generally accepted that a central bank should conduct direct dealings with the public only in such forms and to such extent as, in the circumstances of the particular country, it considers absolutely necessary for the purpose of carrying out its monetary and banking policy."[3] [3 M.H. De Kock, op. Cit., p. 22.]

8.11.1 Function of Central Bank

Economists and financial experts lack in unanimity about the function of a central bank. According to Kishch and Elkin, "the essential function of a central bank is the maintenance of the stability of the monetary standard."[4] De Kock has removed the confusion by mentioning the following seven functions of a central bank in his well-known book Central Banking. According to him, a central bank is a

[4 W.A. Kisch and C.H. Elkin, Central Banking. 4th edition, p. 74.]

Bank of issue.

Banker, agent and financial adviser to government.

Custodian of member bank"s cash reserves.

Custodian of nation"s foreign exchange reserves.

Lender of the last resort.

Bank of central settlement and transfer acting as clearing house.

8.11.2 Controller of Credit

The functions of a central bank are different from those of commercial banks. Firstly, a central bank is established for public service rather than for private profit. Unlike the commercial banks, its operations are not basically guided by profit motive. Secondly, a central bank has special relationship with the government of the country. Since the central bank acts as the banker to the government, the latter informally influences its activities. Thirdly, a central bank generally does not deal directly with the public; it deals with the public only indirectly through the commercial banks and money market. It does not welcome deposits from the public as doing so would amount to usurping the usual banking functions of the commercial banks. This is not, however, to deny that many central banks conducted commercial banking business in the beginning of their career. In fact, almost without exception, central banks before 1914 engaged in the regular commercial banking business with the general public and in some cases on a very substantial scale. With a wide network of branches throughout the country, this brought these banks into some measure of direct competition with the commercial banks. Concern for earnings, moreover, all too often colored their operations and policies to the detriment of their central banking responsibilities-the Bank of England being a good case in point. In this connection, it is pertinent to state that virtually all the central banks before 1914 were privately owned.

8.11.3 Bank of Issue

Central bank enjoys the monopoly of bank note issue, i.e., no bank other than the central bank is authorized by law to print currency notes. Printing of paper currency is one of the most important functions of a modern central bank- "The privilege of note issue was almost everywhere associated with origin and development of central banks. In fact, until the beginning of the twentieth century they were generally known as banks of issue." [M.H. De Kock, op. Cit., p.26.] So much important is this function that in the opinion of Vera Smith it is the essence of central bank's definition. The following are the main reasons for granting the exclusive monopoly of note issue to the central bank.

As the use of deposit money created by the commercial banks increased and with this as the growing need for credit control by a central bank was felt, it was realized that a monopoly of note issue allowed to the central bank made its control over the excessive credit expansion by the commercial banks more effective.

The inherence of the right of note issue in one single bank, particularly when the payment of notes is guaranteed by the government, imparts the notes a distinctive prestige that is absent in the notes issued by several commercial banks.

When the notes are issued by the central bank they carry with them the advantage of uniformity. Although uniformity can also be achieved by means of direct state issue of notes, many examples of depreciation of government notes in the past by shaking the public confidence have caused the state to vest the right of note issue in the central bank.If the right of note issue is exclusively granted to the central bank it is easier for the state to supervise and control the irregularities and malpractices committed by the central bank in issuing notes.

Since the central bank handles the complicated matters relating to monetary management, it is better equipped to solve effectively the problems related to the issuing of notes.

8.11.4 Government Banker, Fiscal Agent and Adviser

Central banks in all countries act as the fiscal agent, banker and adviser on all important financial matters to the governments of their countries. In fact, the older banks performed these functions even before they assumed the name and role of central bank. Bank charters were granted in exchange for loans. We are told by Adam Smith that the earliest banks of Italy, where the name 'bank' began, were finance companies. These were established to make loans to and float loans for the governments of the cities in which they were established. Alfred Marshall also writes that famous early banks like the Bank of Amsterdam acted as fiscal agents for the government. As government banker, the central bank conducts the banking accounts of government departments and enterprises. It gives short-term loans to government in. anticipation of the collection of taxes or the aisingof loans from the public. For example, in Germany the Reiehsbank made the 3-

month loans to the government by discounting treasury bills in anticipation of public loans to be floated every six months to finance the war of 1914 u 18. The central bank also makes extraordinary advances to government during depression, war or other national emergencies. It conducts transactions on behalf of government involving the purchases or sales of foreign currencies. Besides these services, the central bank also performs various other services such as to act as the government. It manages national debt and gives the much-sought-after advice to the government of important matters of economic policy, such as the extent to which deficit financing may be resorted to by the government for accelerating economy's planned economic development without inflation, devaluation of the currency, foreign trade policy, etc. In India, the Reserve Bank of India has advised the Government of India on various important economic policy matters including the stability of prices, funding of the national debt, amount of deficit financing which the economy can absorb etc., during the past four decades.

8.11.5 Custodian of Member Bank's Cash Reserves

As bankers' bank, the central bank performs several functions. It keeps the cash reserves to commercial and other banks in the economy and thus acts as the custodian of the ultimate reserves of the country which support its credit and banking system. The other banks keep their deposits with the central bank. The central bank discounts bills of commercial banks making available to them credit based on these ultimate reserves. It provides able and effective leadership to the banking system in the country. Other banks look to it for guidance and direction, shaping their policy in accordance with its directions. If affects centralization of cash reserves of member banks in the country. "The centralization of cash reserves in the central bank is a source of great strength to the banking system of any country; Centralized cash reserves can at least serve as the basis of a larger and more elastic credit structure than if the same amount were scattered in the individual banks. It is obvious that when bank reserves are pooled in one institution, which is moreover charged with the responsibility of safeguarding the national economic interests, such reserves can be employed to the full extent possible and in the most effective manner during periods of seasonal strain and in financial crises or general emergencies." [M.H. De Kock, op. Cit., p.63.]

8.11.6 Custodian of Nation's Foreign Exchange Reserves

This function of the central bank is derived from its functions as the bank of issue and the custodian of member banks' cash reserves. The essential purpose behind entrusting the custody of nation's foreign exchange reserves to the central bank is the meeting of adverseness at any time in country's external balance of payments and the maintenance of exchange rate stability. To the extent, however, a central bank is required by law to maintain minimum specie reserves against both its note deposit liabilities, its holdings of gold and foreign exchange are immobilized. Consequently, these are not available for maintaining equilibrium in the external balance of international payments.

8.11.7 Lender of the Last Resort

The central bank also acts as lender of the last resort. Historically, this function developed out of the special position of the central bank. The central bank was granted monopoly of note issue in the country and its notes were unlimited legal tender. The centralization of the metallic reserves further added strength to the last resort. In its capacity of lender of the last resort, the central bank meets directly or indirectly all reasonable demands for financial accommodation from the commercial banks, discount houses, and other credit institutions subject to certain terms and conditions which constitute its discount rate policy. Today, this function is regarded as the sine qua non of central banking.

The great importance of central bank's function as lender of the last resort was stressed by Walter Bagehot in 1873 in his well-known book Lombard Street wherein he drew the attention of the Bank of England to act as tender of the last resort by providing rediscount facilities to the banking system in times of financial crises if it had to be called the true central bank. The classic statement of Bagehot runs thus: "Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities quickly, freely and readily. By that policy they alley a panic; by every other policy they intensify it. The public have a right to know whether the Bank of England u the holders of our ultimate bank reserve -

an knowledge this duty, and are ready to perform it. But this is now very uncertain." [Walter Bagehot, Lombard Street, reprint of 1873 edition, 1962 p.85]

8.11.8 Bank of Central Clearance, Settlement and Transfer

This function was first developed by the Bank of England toward the middle of the nineteenth century. In 1854, a scheme was adopted for setting the difference between various banks at the end of daily clearing through the transfer entries between the accounts of different bank kept at the Bank of England. This function of clearance, settlement, and transfer of mutual claims, which was evolved as a method of practice, became, in due course of time, an accepted normal function of the central bank as bankers' bank. Some central banks performed this function because if found place in their laws or articles of association and memoranda. For instance, the Central Bank of Chile as required to act statutorily as a "Clearing House for member banks in Santiago and other cities of the Republic in which it has branches." The Bank of Columbia was also similarly enjoined. One of the purposes of the reconstituted Reich bank and of the National Banks of Austria and Hungary, as mentioned in their laws, was "to facilitate the clearance of payments." Today, the clearing function is a necessary function of a central bank. Stressing this function of the central bank, Shaw asserts that "a central bank will operate as the clearing house for all its member banks as a mere matter of mechanism of book-keeping." [W.A. Shaw, Theory and Principles of Central Banking, p. 115.] According to Kisch and Elkin, it is necessary for the central bank "to set up an expeditious and economical machinery for the clearance of drafts and settlement of internal accounts" because in its capacity 'as holder of the balances of the commercial banks a central bank is specially qualified for this duty." [W.A. Kisch and C.H. Elkin, Central Banking, 4th edition, p. 144.] According to Jauncey, "clearing as the main operation of central banking". [L.C. Jauncey, Australia's Government Bank, p. 166.] Willis also holds that "the clearing function with its ancillary element - is among the most significant of central banking functions and is one for which only a very incomplete substitute may be found through resort to other expedients." [H.P. Willis, Theory and Practice of Central Banking, p. 359.]

Since commercial banks keep their surplus cash reserves in deposits with the central bank it is far easier to clear and settle claims between them by making transfer entries in their accounts maintained with the central bank than if each commercial bank entered into separate clearance and settlement transactions with other banks individually. Much labor and inconvenience experiences in the individual system of clearance and settlement is avoided when central bank enters into the picture as a central clearing agency. The process of effecting settlements between the banks in the books of central bank while comparatively simple to operate is of great convenience to the banking community as it economizes the use of money in banking operations. H.P. Willis has ably highlighted the significance of clearing and settlement functions performed by the central bank in these words: "It is not only a means of economizing cash and capital, but is also a means of testing at any time the degree of liquidity which the community is maintaining u a matter which is essential for the central bank to know from day to day." He goes to the extent of stating that" the attitude adopted (throughout his book) has been that of treating clearance as a test of liquidity" and that ° the bank performs its characteristic function by determining what classed of goods are to be admitted to the field of exchange and the process of clearing indicates the extent to which the judgments which have thus been registered by the bank, have been sound, or at least in accordance with the judgments of other elements in the productive processes of the community." [H.P. Willis, op. Cit., p, 313 ends 350.]

8.11.9 Controller of Credit

The principles of credit control by the central bank were discovered and enunciated after the publication of Bagehot's Lombard Street in 1873. Even after1873, the criteria by which the central bank acted were almost entirely rules if thumb and little or no attempt was made at conscious control in pursuit of a consistent policy before World War I. Today, however, control of credit is the most important function of a central bank and it embraces the most important aspects of the central banking policy. It is through this function that all the other functions are united and server a common purpose. So important is this function that it finds place in the laws of all central banks. For example the Reserve Bank of India Act, 1934 states that Bank is "generally to operate the currency

and credit system of the country to its advantage." The need for controlling credit is obvious. .Credit has become more important than money although latter is the basis of the former. Unwarranted fluctuations in the volume of credit by causing wide fluctuations in the value of money cause great social and economic unrest in the country. The experience of last one hundred years is a testimony to the need of controlling credit in order to maintain the economic and political stability in the economy.

8.11.9.1 Objective of Credit Control

The old objective of controlling credit creation by the commercial banks in the country was dictated by considerations of maintaining, stability of the rate of foreign exchange. The international gold standard was maintained for this purpose from 1875 to 1914. During the war period of 1914 0 1918, it was temporarily suspended but it was re-established in the postwar period from 1919 in 1928 in various forms and degrees. But exchange rate stability was incompatible with the domestic price stability. Exchange rate stability was possible at the heavy cost of causing fluctuations in the domestic and international prices. Consequently, such exchange rate stability was followed by fluctuations in the level of economic activity. Naturally, with the passage of time thought was given to the maintenance of price stability instead of exchange rate stability as the main objective of credit policy of the central bank. The main reason for emphasising exchange rate stability as the goal of central bank's credit policy before the breakdown of the international gold standard in 1936 rested on the universal belief that exchange rate stability was" essential for international prestige of a country ' and for the smooth flow of international trade and lending.

After the breakdown of international gold standard in the thirties, price stability as the goal of economic policy attracted more attention. The economic rot brought by the great depression of the thirties convinced the economists and financial experts of the futility of achieving exchange rate stability in the domestic economy of a country. The opinion that price stability should be preferred to exchange rate stability if the former was incompatible with the latter gained support on the plea that stabilization of domestic prices was most conductive to the national economic welfare.

8.11.9.2 Evaluation

Notwithstanding that the central bank several weapons at its disposal to control money and credit supply in the system, it has seldom bee fully successful in controlling credit. Consequently, booms and slumps still rape the free enterprise economics. In fact, inflation and deflation continue to plague the economic system despite the increase in the number and sophistication of credit control instruments at the command of central bank. While the power of the central bank to control inflation is greater than is its power to arrest deflation this power is severely circumscribed. The central bank can control inflation or deflation only in so far as it is a matter of increasing -or decreasing the aggregate supply of money and credit in the economy. And even in this matter the central bank does not enjoy absolute power in practice. Its actions based on the sound financial and economic considerations are often thwarted by governments on political considerations. In recent years, the governments have been increasingly intervening in the economic and financial policies reserving to themselves decisions that used to be left to the central banks. To be effective against the boom or slump, the credit control instruments at the disposal of central bank should be applied early as delay in this matter is fatal. The more it allows the boom to go its way, the weaker will be its power to check it. But that is what is most difficult for the central bank to do no political grounds. "The stage of the business cycle at which central banking policy has most chance of success is, then, the stage at which it is humanly and politically hardest for the central bank to take resolute action. A study of monetary history justifies the statement that booms - or, for that matter slumps-are never checked early enough". [Geoffrey Crowther, An Outline of Money, revised edition, 1958 reprint, p. 197.]

Moreover, the central bank has no method at its disposal by which it can change investors' human psychology. It is here that a definite limit to the powers of central bank to control credit arises. In order to be perfect in its power to control credit in the economy, the central bank must swim continuously against the current of public feeling-the feeling of over-optimism and over-pessimism- because it is these alternating changes in the psychology of the public which are responsible for the swings of booms and slums. But experience does not support the view that central bank can swim against

the current of public feeling in times when it must. This however, does not mean that things cannot be improved. In fact, there is sufficient scope for improvement in the theory and practice of central bank's credit control policy. Provided that central bank is given more powers and it concentrated its efforts in the quest of equilibrium and provided that it decides to act as other governor and safety valve of an economic mechanism which is constantly prone to get out" of hand," it can go a long way in maintaining the much-needed economic stability in the economic system.

8.11.10 Central Bank in Underdeveloped Economy

In an underdeveloped economy where the commercial banks are either not developed or are scantily developed, where money and capital markets are unorganized and sluggish and where the bill market is almost non-existent, the central bank has necessarily to play a more positive and dynamic role in the rapid development of sound commercial banking system and the money and capital markets in the economy than it is expected to play in a mature economy with its already fully developed commercial banking system and organized money and capital markets. In an underdeveloped economy where commercial banking system is not developed, the central bank must also provide the ordinary banking facilities to the community. Although there are substantial arguments against central bank's engaging in activities directly related to general public, according to Sayers, in an underdeveloped economy the central bank may be allowed to undertake, besides performing its duties as a central bank, commercial banking activities. Where the commercial banking system is inadequately developed, the central bank should supplement the ordinary commercial banking facilities that "are available in the country in a small measure in addition to performing its accepted central banking functions.

Where the central bank is reluctant to undertake directly those banking functions that are traditionally assigned to the commercial banks, it can encourage the development of a viable commercial banking system in the country. In those underdeveloped countries where the conditions are more favorable, the central bank can supplement the existing commercial banking activities as well as encourage the

development of an integrated commercial banking system in the country. The development of the commercial banking institutions can be encouraged partly by means of providing cheap and liberal rediscounting facilities to the commercial banks and partly by giving of subsidy to the newly established commercial banks. Since the giving of subsidy to the newly established banking units entails substantial expenses which the central bank may be unable to bear, subsidy may. Be given by the government through and on the advice of the central bank of the country. The provision of adequate and cheap rediscounting facilities to the commercial banks and be made possible by the government by reducing the stamp duty on certain types of credit instruments on the suggestion and advice of the central bank.

To help the development of a sound commercial banking system in the country, in an underdeveloped country the central bank should play its role of an effective agency for providing the essential map-power and other technical inputs to the commercial banks to enable them to function properly in providing efficient banking services to the community- One of such inputs is the provision of adequate trained personnel to the commercial banks. Since in an underdeveloped country the individual commercial banks are mostly of small size in the matter of financial resources, they cannot bear expenses of establishing their own management training schools and colleges. The central bank must, therefore, establish and manage staff training schools and colleges where the clerical, junior, middle and senior level staff of commercial banks may receive training in the theory and practice of commercial banking. In an underdeveloped economy, the central bank must also prepare the branch expansion programme for the commercial banks in such a manner that balanced development of a viable commercial banking system in the economy may be promoted. In the remote backward regions of the economy, commercial banks may be encouraged to open more branches by providing them various positive monetary and non-monetary incentives.

Consequently, its monetary policy must serve as an effective instrument of planned economic growth with stability. Apart from performing the traditional functions performed by central banks in the developed countries, central bank in an underdeveloped economy has to perform many developmental functions in order to initiate and accelerate

the economic development of term-lending institutions to make available the adequate amount of ingestible funds required of the development of agricultural, industrial and foreign trade sectors of the economy. The central bank must also create agencies to develop the money and capital markets in the economy because it is through these markets that community's surplus funds are mobilized and made available for productive purposes. The central bank has to assist immensely in the process of capital formation by encouraging mobilization of savings in the economy. Since most underdeveloped countries' economies are rural-oriented where agriculture is the main source of livelihood for the masses, modernization is essential for these countries to get out of the trap of under development. This cannot be done in the absence of provision of adequate credit facilities at cheap cost for the agriculturists. The central bank should provide adequate credit facilities in the form of medium and long-term loans to the agricultural sector of the economy. The provision of adequate supply of credit at cheap interest rate and repayable in easy installments spread over medium and long periods requires the promotion and development of agricultural credit institutions like the land development banks and the agricultural refinance and development corporation by the central bank. The central bank should subscribe to the share capital of the agricultural credit institutions and should also provide massive support for the debenture floatation programmes undertaken by these financial institutions.

In an underdeveloped economy, the modern industrial sector is also either absent or scantily developed. The central bank can and should assist in the development of this sector by promoting specialized industrial financial institutions like the Industrial Development Bank of India, Industrial Finance Corporation and the State Finance Corporations, whose function is to provide the much- needed financial assistance in the form of loans, subscription to equity capital and purchase of debentures of the industrial units in the country. Judging from these different angles, the Reserve Bank of India has been playing the dynamic role of a true central bank in the economy of India.

8.11.11 Government Ownership of Central Bank

In recent years, the issue of nationalization of central banks has attracted great attention in the financial and banking discussions. The recent trends in thought and action seem to favor the nationalization of central bank. Before 1914, virtually all the central banks were privately owned by the share-holders. The main exceptions were the State Bank of Russia, the Bank of Finland, the Bank of England and the Swedish Riksbank. In some cases, e.g., the Bank of Japan and the Bank of Italy, even though these banks in question were privately owned, the government exercised a large measure of direct control in their routine day-to-day operations. The traditional laissez faire control was emphasized at the Brussels Conference of 1920 and the Genoa Conference of 1922. However, Jacob Viner has stated that during 1800-1850, the Bank of England had shown incompetence and inefficiency in managing the currency system of the country.

However, the trend for nationalization of central banks received great impetus after the Second World War and today central banks in most countries have been nationalized. The central banks in Australia, New Zealand, Canada, Denmark and India were nationalized in 1945, 1936, 1938, 1931 and 1949 respectively. The theory behind the nationalisation of central banks seems to be based on the contention that complete government control over central bank, which is not possible without government to frame its economic policy in consonance with the national interests.

The philosophy of subordination of central bank to the state is based on the tradition and belief that the state must enforce some laws to regulate the means by which its citizens should repay or discharge their debts. The state should have adequate powers to regulate the country's monetary affairs which it can only efficiently do by exercising control over the central bank and this control will be absolute and perfect only if it owns the central bank.

Notwithstanding this increasing trend toward government ownership of central banks, of late there has been seen a reversal of trend in the relationship between the government and the central bank. In many countries, public opinion favors granting protection to the central bank against undue political pressure of the government. For

example, in Australia and New Zealand the central bank has been given protection against the exercise of under pressure from the government by the parliament. Nationalisation of the central bank should not give a license to the government to force the central bank to do things according to its caprice. The parliament should keep an eye on the code of relationship between the two so as to enable the central bank to enjoy fair degree of freedom in important monetary and financial matters involving national stake. The central bank should be an independent authority in the government, although not independent of the government and it is a part of its duty to keep the public well informed of the motivations of its current monetary policy. The central bank, it has been argued, should not be subservient to government, if should cooperate with the government but it should have its own ethos and life.

There is much that can be said in favor of a high degree of central bank independence. The central bank must act as a full-fledged partner at the stage when major economic policy decisions are I made by the government affecting the domestic price level, external balance of payments, and monetary and credit conditions in the economy. It must be enabled to help carry out the monetary and banking policies with vigour and courage. This is possible only when the central bank maintains its independent identity rather than merely act as an ordinary and traditional wing of the Treasury. The central bank should not become a mere rubber stamp under the absolute control of the state.

In the reaction against the central bank functioning under the absolute control of the state was aroused by the central bank's functioning in the Central European countries. The truth, however, is that in the present-day context of planned economic development the central bank cannot be left completely free of state control. The government must be empowered to have ultimate control over the actions and policies of its central bank. The question of the state ownership of central bank is vitally linked with that of the state control of central bank. State control points out to the state ownership of one or another kind of a central bank,

Partial Convertibility (LERMS)

In the Union Budget for 1992-93 presented to Parliament or. February 29, 1992, further changes as part of the liberalization package were announced. These included abolition of exports subsidies as also the Exim Scrips introduced in July 1991, introduction of Partial convertibility of Rupee under the scheme know as Liberalised Exchange Rate Management System (LERMS), further reduction in custom tariffs, and placement of most of the imports under open Genera! Licence (OGL). The scope of LERMS was further enlarged with switch over to full convertibility of Rupee on trade amount in the following year.

8.12 SUMMARY

In an underdeveloped economy, the central bank cannot rest contented by performing merely he traditional functions which are performed by it in the developed countries which consist chiefly of controlling the aggregate money supply (M+M') in circulation in the economy. In this respect, the control o credit is the most important function of the central bank. In an underdeveloped economy where the banking habit is little developed and banking offices are very few and the money and capital markets are either absent or scantily developed, the central bank has to play a dynamic role in the planned rapid economic growth of the economy.

8.13 KEY WORDS USED IN THE LESSON

Financial institution

Commercial banks

ICICI

Central bank

Credit Control

8.14 ANSWER TO CHECK YOUR PROGRESS QUESTIONS

1 1956

2 Medium and long

3 25%

4 2 to 5 years.

5 one year to three years

6 1947

7 Devaluation

8.15 Model questions

1. Bring out the organization of International Bank for reconstruction and development.
2. What are the functions of International Finance Corporation?
3. What do you understand by Lines of Credit?
4. Bring out the essential features of Whole Turnover Post-shipment Guarantee.
5. State the functions of International Development Association.
6. What is meant by Devaluation?
7. Write a short note on Bank of Issue.
8. What are the objectives of credit control?

Essay Questions

1. Briefly discuss the contribution of ICICI for the development of International trade.
2. Explain in detail about Special Drawing Rights.
3. Bring out the role of Central Bank in country"s economic development.

8.16 Further Reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

UNIT-IX

THEORIES OF INTERNATIONAL TRADE

UNIT STRUCTURE

9.1 Introduction

9.2 Unit Objectives

9.3. Theory of Absolute Advantage

9.4 Theory of Comparative Advantage

9.5. Hesckscher-Ohlin Model

9.6. Imitation-Gap Theory

9.7 International Product Life Cycle Theory

9.8 Regulation of International Trade

9.9 Mergers and Acquisitions

9.10 Strategic Alliance

9.11 Summary

9.12 Key words used in the lesson

9.13 Answers to check your progress questions

9.14 Model Questions

9.15 Further reading

9.1 INTRODUCTION

In the previous chapter, the various reasons and benefits of the integration of the financial markets were discussed. One important stimulant for this development was the increase in trade among different countries. A well-developed global financial system is essential for supporting increased international trade. The international payment

system, the availability of international credit and credit guarantees (all forming a part of the international financial system), form the backbone of international trade. There are some fundamental issues which still need to be addressed. Why does international trade take place? What makes two entities in two different countries buy from or sell to each other? How it is decided as to which country should export a particular good and which country should import it? Who gains from such trade? A number of theories have been ropounded in an effort to answer these questions. Some of the major theories will be explained in the following sections.

9.2 OBJECTIVES

* To understand the Theory of Absolute Advantage
* To know the Theory of Comparative Advantage
* To study Hesckscher-Ohlin Model
* To identify the Imitation-Gap Theory
* To identify the factors influencing in International Product Life Cycle Theory.

Unit Structure

9.3 THEORY OF ABSOLUTE ADVANTAGE

Check Your Progress

1 Theory of Absolute Advantage proposed by _____.

In 1776, Adam Smith proposed the theory that international trade takes place because one country may be more efficient in producing a particular good than another country, and that other country may be capable of producing some other good more efficiently than the first one. This provides an incentive to trade as both the countries can benefit from specialization and the resultant increase in productivity. Let us elaborate with an example. Suppose there are two countries - Angelland and Babel. Angelland can produce a super computer by using 10 units of labor for the some. On the other hand, to produce an aircraft Angelland requires 20 units of labor and Babel requires only 10 units of labor. All other factors are used in equal amounts by both the countries. Here, Angelland enjoys an absolute advantage in producing super computers and Babel in

reducing aircrafts. According to Adam Smith, in such a scenario, Angelland will restrict itself to producing super computers and Babel to aircrafts. These goods will then be traded among these two countries. Let us assume that the countries exchange I super computer for I aircraft. Angelland will then be able to produce a super computer using 10 units of labor, exchange it for one aircraft and use the remaining 10 units of labor to produce a super computer for its own consumption. This way it will be able to derive the satisfaction of using a super computer as welt as an aircraft by exhausting only 20 units of labor, which would otherwise have yielded only an aircraft. Babel can also benefit in a similar fashion. Thus international trade results in increasing the rate of economic growth of both the countries by utilizing the resources of both the countries more productively. If increasing returns to scale are experienced the benefits are further increased.

There are contain limitations to this theory. Firstly, it explains the causes of trade between two countries only in those situations, where both the countries enjoy absolute advantage in the production of at least one product. Secondly, it assumes that the transportation costs involved in selling commodity in a country other than the one in which it was produced, are either non-existent or insignificant when compared to the degree of comparative advantage. This may not always hold good, A further assumption of the model is that prices are comparable across countries, further implying stability of exchange rates. These assumptions may again not hold good. Lastly, the theory assumes mobility of labor between products. As a country starts concentrating on producing the commodity in which it enjoys a comparative advantage, the labor is assumed to shift from other sectors to that sector. Labor may be mobile, but only to an extent. The kind of adaptability required for labor to be perfectly mobile cannot actually exist.

9.4 THEORY OF COMPARATIVE ADVANTAGE

According to the previous theory, two countries enter into trade when both of them hold an absolute advantage in the production of at least one product. The question which arises next is whether two countries can benefit by trading with each other even if one of them has an absolute advantage in all the commodities. Yes, they can. According to the theory of comparative advantage, propounded by the English economist David

Ricardo in 1817, trade is possible as long as the country experiencing the disadvantages is not equally less efficient in producing all the products, i.e., both the countries enjoy comparative advantage in at least one of the products. Let us take an example to understand what this means.

Continuing with our example of countries Angelland and Babel, let us assume their respective efficiencies in producing steel and cement to be as given in the Table 1.

Table 1

Efficiencies of countries as reflected by the labor-hours used

	Labor-hours required	
	1 unit of steel	1 unit of cement
Angelland	5	10
Babel	15	20

Check Your Progress

2 The theory of comparative advantage propounded by the English economist David Ricardo in the year _____.

As we see, Angelland enjoys an absolute advantage in producing both steel and cement, as the number of labor-hours required to produce one unit of each commodity is lesser than that required by Babel. Let us further assume that both the countries have 600 units of labor-hours at their disposal. These labor units can be used for producing either steel or cement. If Angelland utilizes these units for exclusively producing steel, then it will be able to produce 120 (600/5) steel-units. In case it goes for producing only cement, its capacity would be 60 (600/10) units of cement. Similarly, Babel can produce either 40 units of steel or 30 units of cement. As we see, for producing each unit of steel, the production of a particular number of units of cement has to be foregone, and vice-versa. The quantity of cement thus foregone in order to produce one additional unit of steel is called the opportunity cost of steel. As Angelland can either produce 120 units of steel or 60 units of cement with the available resources, the opportunity cost of steel for Angelland would be 0.5 (60/120). The opportunity costs of

producing steel and cement for the two countries can be similarly calculated. This calculation is shown in Table 2

Table 2

Opportunity costs involved in the production of steel and cement

	Opportunity cost	
	Steel	Cement
Angelland	60/120 = 0.50	120/60=2.00
Babel	30/40 =0.75	40/30 =1.33

Enjoying comparative advantage for a country means having a lesser opportunity cost of domestically producing a commodity than the other country. As we can see from Table 2. Angelland has a lower opportunity cost and hence enjoys a comparative advantage in producing steel, while Babel enjoys it in producing cement. According to the theory of comparative advantage, each country should produce that good, in which it has a comparative advantage. Hence, Angelland should produce steel and Babel should produce cement. This result can be arrived at by one more method. As we see from Table 2.1. Angelland is comparatively more efficient in producing steel than in producing cement. It consumes only one -third the units of labor that Babel needs to produce a unit of steel, while in the case of cement it needs half the labor-units required by Babel. Thus, Angelland should produce steel since it is comparatively more efficient in steel production. This gives us the same result as given by the measurement of comparative advantage.

The analysis of comparative advantages has helped us to decide as to which country should produce which commodity. Now we have to understand how this specialization in production and the consequent trade will help the two countries in increasing their standard of living. Assume the state of autarky, i.e., the state where no

cross-border trade takes place. Angelland foregoes 0.5 units of cement for every one unit of steel it produces. At the same time, Babel foregoes 1.33 units of steel for every unit of cement that it manufactures. Introducing international trade in the picture, if Angelland could get more than 0.5 units of cement in exchange for one unit of steel, it will gain. Similarly, if Babel could sell a unit of cement for more than 1.33 units of steel, it will also benefit from trade. In other words, Babel would benefit if it could get a unit of steel for less than 0.75(=1/1.33 units of cement. Hence, both the countries can benefit if a unit of steel can be traded in the international market for anywhere between 0.5 and 0, 75 units of cement. According to the theory of comparative advantage, Angelland should produce only steel and Babel only cement and they should trade these in the international markets for mutual benefit. Let's say, the international terms of trade are 0.65 units of cement per unit of steel. If Angelland produces one unit of steel using 5 units of labor in the process, and trades it for 0.65 units of cement, it will save 1.5 units of labor (0.65 x 10-5). These labor- units can be used to produce additional units of steel for consumption at home or to be exchanged for more units of cement. Similarly, Babel can save 2 units of labor by producing 0:65 units of cement and trading it for a unit of steel (15-0.65 x 20). These units can also be used for further production of cement, either for home consumption or for further trade. These gains are referred to as gains from trade. Thus, we see that international trade benefits, irrespective of whether a country enjoys absolute advantage in the production of any product or not.

In explaining the theory of comparative advantage, David Ricardo made certain implicit assumptions. They are

1. Perfect competition

Perfect competition with flexible prices and wages prevails in both the countries. This result in the prices of steel and cement being different in Angelland and Babel due to a difference in the labor-hours used and hence used and hence the production costs.

2. Productivity of labor

Labor is the only factor of production and the average product of labor is constant for producing both the products in both the countries. This means that the marginal product of labor is constant, implying constant returns to scale.

3. Full employment

There is full employment in both the countries. This assumption is necessary for calculating the opportunity costs of the goods by making a choice between the productions of the two goods compulsory.

4. Mobility

Labor is perfectly mobile between various sectors'" but perfectly immobile between countries.

5. Technology

No technological innovation takes place in any of the economies. This assumption is also necessary for keeping the marginal product of labor, and hence the comparative advantages, constant.

As the two countries start trading, the conditions in the domestic markets change. As demand of steel in Angelland increases due/to export demand, price of steel in that country .will rise. Similarly, the price of cement in Babel will also rise. Meanwhile, the increase in supply due to import of cement in Angelland and steel in Babel will reduce the prices of these goods in the respective countries. The change in the domestic prices will result in a change in the profitability involved in the production of these goods. As production of steel becomes more profitable and that of cement becomes less profitable in Angelland, there will be a shift in production in that country from cement to steel. There will be a similar shift in production in Babel from steel to cement. As a result of the shift in production, the labor also moves from one sector to the other. This process will continue till the relative prices in the countries involved are equalized for both the commodities.

This theory is also not free from limitations. What if labor is not able to shift from one sector to the other in response to the shift in production? Will the theory still hold good? In such a case, unemployment in the economy will rise and the country will end up even less efficient than it was under the state of autarky. So when the economy is in the grip of a recession or malfunctions, the theory of comparative advantage may not work. The reason world trade order broke down during the Great Depression of 1930s can easily traced to the soaring unemployment and falling outputs all over the world. International trade again picked up after the Second World War when the manifold increase in trade among the industrialized nations led to unprecedented economic growth. Thus, we can say that the theory of comparative advantage works properly when the economy is generally in equilibrium and various economic indicators like the exchange rate, prices and wages are at their appropriate levels. Disequilibrium in the economy like the declining part of an economic cycle makes it go haywire. Similarly, some other assumptions of the theory like perfect competition and absence of technological innovation are very rigorous. The theory also leaves the reasons giving rise to comparative advantage untouched. In addition, it suffers from all the drawbacks of the theory of absolute advantage. Yet, despite the drawbacks, this theory is one of the closest explanations of international trade and the benefits derived from it. No nation desirous of prospering and achieving high levels of economic growth can afford to ignore it.

9.5 Heckscher-Ohlin Model

The theory of comparative advantage assumes a single factor of production-labor-and describes the situation where trade takes place between countries having different technologies, i.e., the countries operating at different levels of efficiency giving rise to comparative advantages. The Heckscher-Ohlin model developed by Eli Heckscher and Bertil Ohiin in the 1920s, explores the possibility of two nations operating at the same level of efficiency, benefiting by trading with each other. Following are the assumptions of the model:

1. No obstructions to trade (for e.g. trade controls, transport costs) are there.

2. Both commodity and factor markets are perfectly competitive.

3. There are constant or decreasing returns to scale.
4. Both the countries have the same technology and hence operate at the same level efficiency.
5. There are two factors of production-labor and capital. Both are perfectly immobile for interll country transfers, but perfectly mobile for inter-sector transfers.

According to this theory, there are two types of products - labor intensive and capital intensive The model further says that the reason two countries operating at the same level of efficiency can and do benefits from trade can be traced to the differences in their factor endowments. The labor-rich country is more likely to produce labor-intensive goods and the country rich in capital will most probably produce capital-intensive goods. The two countries will then trade these goods and reap the benefits of international trade.

Just as having a higher per capita income, rather than having a higher national income should be the criteria for judging as to which country is richer; for judging as to which country is capital-rich, the criteria should be greater physical amount of capital per unit of labor rather than abundance of capital. There is another way of categorizing a country as capital-rich or labor-rich. The country where capital is cheaper than in the other country under the condition of autarky can be called as capital-rich. The theory always holds good if we categorize the countries on the basis of factor prices. If the amount of factor is used as the basis of categorization, then to make the theory valid, we have to make the additional assumption that the tastes of the consumers are identical and homothetic in both the countries. This is so, because a bias in consumer tastes towards consumption of labor- intensive goods in an economy which is physically capital-rich, or vice-versa, can distort the factor prices so as to make the relative price of a capital-intensive good higher in the physically capital-rich country. This would result in a contradiction between the categorizations made on the basis of the two different interpretations of factors abundance. The assumption of identical tastes removes this obstacle.

The Heckscher-Ohlin model is also not free from drawbacks. Firstly, it assumes that factor endowments are given, whereas they can also be developed through innovation. Secondly, due to minimum wage laws existing in some countries, the factor prices may change to such an extent, that an otherwise labor-rich country may find it cheaper to import labor intensive goods than to produce them locally. Finally, the findings of an empirical study by economist Wassily Leontief pointed out that despite being a capital-rich country, US exports are more labor-intensive than capital-intensive. All these factors highlight the fact that there is more to international trade than just factor endowments. In case of US exports, as Leontief found out, it was the availability of highly skilled and educated labor that prompted the US to export labor intensive goods.

9.6 Imitations-Gap Theory

This theory, given by Posner, considers the possibility of trade between two countries having similar factor endowments and consumer tastes. According to this theory, improvement in technology is a continuous process and the resulting inventions and innovations in existing products give rise to trade between such countries.

Check Your Progress

3 Imitation-Gap Theory considers the possibility of trade between_____ countries having similar factor endowments and consumer tastes

The degree of trade between such countries will depend upon the difference between the demand lag and the imitation lag. Demand lag is the difference between the times a new or an improved product is introduced in one country, and the time when consumers in the other country start demanding it. Imitation lag is the difference between the times of introduction of the producers in the other country start producing it. Imitation lag depends on a number of factors including the readiness of the producers in the second country to adopt new technology, availability of patent protection to the original producer, time taken by the second country producers to learn the new process and to adapt the existing plant and machinery to it, the simplicity or otherwise of the innovation, and the likelihood of the second country producers developing the technology on their own due to a constant process of research and development. Demand lag depends to a large extent on the speed and effectiveness of flow of information, the readiness of the consumers in the second country to use innovative products, the speed with which they react to changes in technology, "and their ability to convert their desires into demand

(i.e., their financial ability to purchase the products). If due to any of the above factors, the imitation lag is shorter than the demand lag, no trade will take place between the two countries. However, normally demand lag can be expected tote shorter than imitation lag. In such a case, the country coming out with the innovation will be able to start exporting to the second country as the consumers there aware of its product, and the exports will keep growing as more and more consumers become aware. These exports will continue to increase till the demand lag is over, i.e., till all the consumers react to the innovation. If the local producers can start producing the same product before this time period, they can arrest the growth of these imports into their country, otherwise the exports will continue and will stabilize at a particular level. At the end of the imitation lag, the trade will start coming down and will be finally eliminated. If due to further technological innovations in the first country, it is able to come out with a still better product before the elimination of these exports, the second cycle would start before the first one has ended. On the other and, if there are no further innovations in the first country and the second country producers are able to come out worth another new product due to the stimulation received by research in their country, the whole cycle will reverse.

Check Your Progress

4 Two important factors considered by International Product Life Cycle Theory are _____ and _____.

9.7 INTERNATIONAL PRODUCT LIFE CYCLE THEORY

The international product life cycle (IPLC) theory, given by Vermon, explains the various stages in the life of a new product and the resultant international trade. Two important factors considered by this theory (and generally ignored by the other theories) are technological innovation and market structure. The important principles of this theory are

new products are developed as a result of technological innovations.

trade patterns are determined by the market structure and the phase in a new product's life.

According to this theory, innovations are generally concentrated in the richer, more developed countries. In the early stages of a new product, it is produced and exported by the country which introduced the innovation. In the second stage of the life

of the product, production may shift to other developed countries where the factors required are in abundance and thus offer a cost advantage. In the third and the final stage, production shifts to lesser developed countries. This process results in the originally exporting country becoming the importer.

There are two major reasons for innovations to be concentrated in the capital countries. The First reason is that the environment in the capital-rich countries happens to be more conductive to research and development, which forms the backbone of innovations. This is so because the patent regulations are more effective there, along with a favorable tax structure. R&D generally requires a lot of money and skilled labor, which are available aplenty in capital-rich countries. The second incentive for such countries to create new innovation is that the countries there generally have high incomes and are ready to try new products.

Once new products are developed, they are first produced in the country that develops them. The reasons are quite similar to the ones which promote R&D to take place in such countries. Since the production of a new product is generally very risky (as it is highly priced because of it being an improvement over the existing products), the producers will feel more comfortable if the consumers it is directed at, are having relatively high incomes. The production of such goods also requires flexibility on the production side, which is made possible by the availability of skilled labor in such economies. When a product is in its initial stages, it is much more beneficial, even essential, to be at a close proximity to the ultimate consumer. This again favors production to take place in these countries, rather than some far off country which may be endowed with better suited factors of production. Initially, these goods are produced for local consumption and due to price inelasticity, high profits are enjoyed by the producers. These high profits encourage increased production, and as supply starts outstripping demand, the country starts exporting to the rest of the world.

As the product enters the maturity stage and the factor requirement changes, the center of production also shifts from the country which initially introduced the innovation, to other developed countries which may offer a cost advantage due to a more

suitable pattern of factor prices- The actor requirements may change due to standardization of the product and its manufacturing process taking place some time of the introduction of the product in the markets. The entry of other countries in the production scene may also be facilitated by the expiry of the patent granted at the time of the innovation or the development of substitutes in other countries. As the production process may still require highly skilled labor and the product may be expensive enough to need high-income consumers, production may shift only to other developed countries. Also, the substitutes are likely to first come up in other developed countries. The exports from the country which came out with the innovation would decline in this phase, and those from these other developed countries will register an increase.

After passage of some more time, the production process would become totally standardized and it would become possible to produce the good with relatively unskilled labor. Also, as the technology would become easily available, producers in relatively less developed countries would become interested in producing the good. By this time, the country introducing the innovation could also be reasonably expected to come out with still newer technology, making the earlier product cheaper and affordable by the residents of these lesser developed countries. All these factors would result in. the shifting of production to the 'after. "Thus, in the last phase of the product life cycle, these countries would start exporting the standardized product and the countries earlier engaged in its production and export would face a decline in their exports, some of them even becoming importers of the same product. It is important to remember here that since different versions of the same product may be at different stages of their life cycle at the same time, a country may be exporting as well as importing the same product, albeit different versions, at any given point of time.

9.7.1 Infra-Industry Trade

The theories discussed in the last few paragraphs explain why one country exports some products to a few countries, while importing other products. Another interesting phenomenon observed is that of a particular country simultaneously importing and exporting the same product. This is referred to as intra-industry trade. Why does

intra-industry trade take place? A number of reasons can be attributed to the popularity of such trade. A few of them are given below:

One reason which promotes inter-industry trade is transportation costs. The distance (and hence the transportation costs involved) may be lesser between city X in Angelland and a city in Babel, than between city X and city Y in the same country (i.e., Angelland). This would encourage consumers staying in city X to import from Babel rather than buy from within their own country. If Angelland is involved in exporting the same good to other countries, it will effetely end up being engaged in intra-industry trade.

Session differences provide another reason for intra-industry trade. A country may import a particular foodstuff when it is not in season in that part of the world and may export it when it comes in season.

Product differentiation also promotes such trade. It is generally observed that capital-rich countries export superior quality varieties of the capital-intensive products, while the labor-rich countries export both the labor-intensive products and the lower quality varieties of the capital-intensive products. If demands for both lower and higher quality goods exist in both types of countries, it would again result in intra-industry trade. However, international trade due to product differentiation need not necessarily be a result of difference in qualities. Trade may also take place due to the existence of different brands. For e.g., the US exports one brand of automobiles while importing another.

In addition to the above theories, there are a few more factors affecting international trade. These are

High re-entry costs

A firm temporarily facing a slump in international demand and/or price for its product may have to continue its supply, even if it is not economically justifiable, due to high re-entry costs. In such a situation, international trade will take place despite a comparative disadvantage being faced by the firm.

Economies of scale

Economies of scale may encourage a firm to produce more in order to attain lower per unit cost. This additional output would then be unloaded in the foreign markets. Thus, a firm may be able to export even without enjoying comparative advantage, as a result of scale economies.

Currency value

Exchange rates, i.e., value of one currency in terms of another currency may increase or decrease the competitiveness of a product in the international markets. This may result in a change in the trading pattern among nations.

Consumer tastes and imperfect competition

Consumer tastes are an important factor governing international tastes. Due to a perceived difference in quality, brand image of a particular product, or some other psychological reason, consumers may be ready to purchase a more expensive product despite a similar product being available for a lesser price. This may also happen in case of imperfect competition prevailing where information about the availability of the cheaper product may not be held by a section of the consumers. There factors would distort the trade patterns.

9.7.2 Growth of International Trade

As we have seen, trade among nations induces countries to specialize in particular products or in particular varieties of some products. This results in a more efficient allocation and utilization of world resources. As the producers benefit from specialization and economies of scale and the consumers get a wider range of products to choose from, the economic activity increases, thus giving a push to economic growth the world over. Countries have been trading with each other for several centuries, but as countries began to appreciate the above-mentioned fact, international trade started growing by leaps and bounds. There have been times when countries showed a reduced interest in such trade and adopted various measures to protect their domestic industries

which resulted in a drawback to the growth, but such times have their roots in the underlying weak economic variables. These protectionist measures were introduced for tiding over temporary difficulties such as the Great Depression of 1930s rather than out of any general disinclination towards trade. In fact, during the last half-a-century, international trade has grown at a rate faster than that of the GDPs of the countries involved. AS a result, an export as a percentage of GDP has increased dramatically for a number of countries.

9.7.3 Risks involved in International Trade

Risks and rewards always go hand-in-hand. True to this maxim, the advantages of international trade are not unaccompanied by additional risk. There are two types of additional risks that have to be taken care of while trading across nations- exchange risk and country risk. Exchange risk is the uncertainty of returns induced by unexpected changes in exchange rates. As exchange rates change unexpectedly, they may have an unfavorable effect on sales, prices, costs and profits of exporters and importers. Country risk refers to the risk of an exporter not receiving his payment from the importer due to some country specific reasons. These reasons may be political (like war), social civil war), or economic (extreme liquidity crunch in the economy). Even when the capacity of the importer to pay is not impaired by any of these reasons, the payment may not come through due to some currency exchange restriction suddenly imposed by the importing country. Respite these additional risks, international trade has proved to be an attractive proposition.

9.7.4 Emergence of Trading Blocks

An important phenomenon that took place as trade among nations grew, was that of countries of the same regions coming together to form close trading ties. Various forms of trading blocks emerged as international trade grew, and contributed to its further growth. These blocks differ in respect of the degree of economic co-operation between member countries. The different forms of trading blocks are

free trade area

customs union

common market

economic union.

The various forms of trading blocks are discussed below.

9.7.4.1 Free Trade Area

In a free area, there are two no barriers to trade among the member countries. At the same time, the member countries individually decide upon their trade policies, as applicable to non-member countries. Measures like insisting for „certificate of origin" are used to avoid the possibly of diversion of trade within the free trade area from high-external-barriers countries to low-external-barriers countries.

9.7.4.2 Customs Union

Under a customs union, in addition to the absence of internal trade barriers among the member nations, the external barriers for non-members are also common.

9.7.4.3 Common Market: A common market allows free flow among member-nation of not only goods, but also factors of production (labor and capital) and services.

9.7.4.4 Economic Union

The members of an economic union have completely co-coordinated economic and social policies. There is a unified central bank and a common currency. The fiscal as well as monetary policies are well co-coordinated, some of them being decided upon by the central bank. Even the policies on agriculture, industry, research, welfare, regional development, competition etc. are the same across member-nations. The countries forming an economic union have to give up a lot of economic and social freedom in favor of the central decision-making authority.

Some examples of existing trading blocks are

9.7.5 North American Free Trade Area (NAFTA)

In 1988, the United States of America and Canada entered into a free trade agreement which was joined in 1993 by Mexico to form the NAFTA. A step-by-step elimination of barriers to the flow of goods, services and investment was decided upon.

9.7.6 Association of South East Asian Nations (ASEAN)

Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand formed ASEAN in 1967 by signing the Bangkok Declaration. Myanmar and Vietnam also joined the group later. ASEAN is an organization for economic, political, social and cultural co-operation among its members. It aims at becoming a free trade area.

Check Your Progress

5 ASEAN stands for _____.

9.7.7 South Asia Free Trade Area (SAFTA)

The seven SAARC nations - Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka entered into the South Asia Preferential Trading Agreement (SAPTA) and have announced plans to create a free trade area called SAFTA.

9.7.8 Southern Cone Common Market (MERCOSUR)

In March 1991, Argentina, Brazil, Paraguay and Uruguay decided to form a common market for goods, services, capital and labor by the name of MERCOSUR. They also agreed to follow common trade, agriculture, transport and communications policies.

9.7.9 The European Union

One of the most important and constantly evolving trading blocks is the European Economic Community (EEC) established in March 1957 by the signing of the Treaty of Rome. The treaty came into effect on January 1, 1958. The treaty was initially signed by Belgium, France, Germany, Italy, Luxembourg and the Netherlands. These countries were later joined by the Denmark, Ireland and the United Kingdom in 1973. The membership now stands at 15 with Austria, Finland, Greece, Portugal, Spain and Sweden joining at different points of time. This group is now known as the European Union. The EU operated as a customs union for some time, transforming itself into a

common market with effect January 1, 1993. With a common central bank created in 1998, this union is now known as the European and Monetary Union (EMU). It launched a common currency (named Euro) on January 1, 1999 and aims to finally achieve the status of a monetary union.

These various associations between countries in different forms have helped the growth of international trade immensely.

9.7.10 Trade Barriers

Despite all the obvious benefits of international trade, governments have an inclination to put up trade barriers in order to discourage imports. There are two kinds of barriers; tariff and non-tariff.

9.7.11 Tariff Barriers

Tariff is a tax levied on goods traded internationally. When imposed on goods being brought into the country, it is referred to as an import duty. Import duty is levied to increase the effective cost of imported goods in order to increase the demand for domestically produced goods. Another type of tariff, less frequently imposed, is the export duty which is levied on goods being taken out of the country, to discourage the export of those goods. This may be done if the country is facing a shortage of that particular commodity or if the government wants to promote the export of that good in some other form, for e.g.., a processed form rather than in raw material form. It may also be done to discourage exporting of natural resources. When imposed on goods passing through the country, the tariff is called transit duty.

Tariff can be imposed on there different bases. A specific duty is a flat duty based on the number of units regardless of the value of the goods. For example, there may be a duty of Rs. 5,000 per computer imported into India. In this case, a person importing, say, 20 computers would have to pay a duty of (5,000 x 20 =) Rs. 1,00,000. An ad valorem duty is expressed as a percentage of the value of the good. So a person importing duty of 10% would have to pay Rs. 200 towards duty charges. A compound duty is a combination of a specific and an ad valorem duty. For example, a book worth

Rs. 500 carrying a specific duty Rs. 25 and an ad valorem duty of 2% would in effect be carrying compound duty of Rs. 35.

Over the last few decades, tariffs have been losing their importance as barriers to trade, their place being taken by non-tariff barriers.

9.7.12 Non-tariff Barriers

Non-tariff barriers (NTBs) include all the rules, regulations and bureaucratic delays which help in keeping foreign goods out of the domestic markets. There are different types of NTBs.

9.7.12.1 Quota A quota is a limit on the number of units that can be imported or the market share that can be held by foreign producers. For example, the US has imposed a quota on textiles imported from India and other countries. Deliberate processing of import permits under a quota system acts as a further barrier to trade.

9.7.12.2 Embarg When imports from a particular country are totally banned, it is called an embargo. It is mostly put in place due to political reasons. For example, the United Nations imposed an embargo on trade with Iraq as a part of economic sanctions in 1990.

Voluntary Export Restraint (VER)

A country facing a persistent, huge trade deficit against another country may pressurize it to adhere to a self-imposed limit on the exports to the deficit facing country. This act of limiting exports is referred to as voluntary export restraint. After facing consistent trade deficits over a number of years with Japan, the US persuaded it to impose such limits on itself.

Subsidies to Local Goods

Governments may directly or indirectly subsidize local production in an effort to make it more competitive in the domestic and foreign markets. For example, tax benefits may be extended to a firm producing in a certain part of the country to reduce regional imbalances, or duty drawbacks may be allowed for expected goods, or, as an

extreme case, local firms may be given direct subsidies to enable them to sell their goods at a lower price than foreign firms.

Local Content Requirement

A foreign company may find it more cost effective or otherwise attractive to assemble its goods in the market in which it expects to sell its product, rather than exporting the assembled product itself. In such a case, the company may be forced to produce a minimum percentage of the value added locally. This benefits the importing country in two ways - it reduces its imports and it increases the employment opportunities in the local market.

9.7.13 Technical Barriers

Countries generally specify some quality standards to be met by imported goods for various health, welfare and safety reasons. This facility can be misused for blocking the import of certain goods from specific countries by setting up of such standards which deliberately exclude these products. The process is further complicated by the requirement that testing and certification of the products regarding their meeting the set standards be done only in the importing country. These testing procedures being expensive, time consuming and cumbersome to the exporters, act as a trade barrier. Under the new system of international trade, trading partners are required to consult each other before, fixing such standards. It also requires that the domestic and imported goods be treated equally as far as testing and certification procedures are concerned and that there should be no disparity between the quality standards required to be fulfilled by these two. The importing country is now expected to accept testing done in the exporting country.

Procurement Policies

Governments quite often follow the policy of procuring their requirements (including that of government-owned companies) only from local producers, or at least extend some price advantage to them. This closes a big prospective market to the foreign producers.

9.7.14 International Price Fixing

Some commodities are produced by a limited number of producers scattered around the world. In such cases, these producers may come together to form a cartel and limit the production or price of the commodity so as to protect their profits. OPEC (Organization of Petroleum Exporting Countries) is an example of such cartel formation. This artificial limitation on the production and price of the commodity makes international trade less efficient than it could have been.

9.7.15 Exchange Controls

Controlling the amount of foreign exchange available to residents for purchasing foreign goods domestically or while traveling abroad is another way of restricting imports.

9.7.15.1 Direct and Indirect Restrictions on Foreign Investments

A country may directly restrict foreign investment to some specific sectors or up to a certain percentage of equity. Indirect restrictions may come in the form of limits on profits that can be repatriated or prohibition or payment of royalty to a foreign parent company. These restrictions serve to discourage foreign producers from setting up domestic operations. Foreign companies are generally interested in setting up local operations if they foresee increased sales or reduced costs as a consequence. Restrictions against foreign investment, thus, act as an impediment to international trade by giving rise to inefficiencies.

9.7.15.2 Customs Valuation

There is a widely held view that the invoice values of goods traded internationally do not reflect their real cost. This gave rise to a very subjective system of valuation of imports and exports for levy of duty. If the value attributed to a particular product would turn out to be substantially higher than its real cost, it could result in affecting its competitiveness by increasing the total cost to the importer due to the excess duty. This would again act as a barrier to international trade. This problem has now been

considerably reduced due to an agreement between various countries regarding the valuation of goods involved in cross-border trade.

9.7.15.3 Transportation Costs

These costs act as another trade barrier. The cost of moving goods from one market to another has the same effect as tariffs. While tariffs are imposed by governments, transportation costs act as natural barriers to trade.

9.7.15.4 Comparison between Quotas and Tariffs

Any kind of trade barrier reduces the efficient allocation of world resources and the achievable level of standard of living. Both quotas and tariffs cause this to happen. Yet, there are some differences between the two. The imposition of a tariff generates revenue for the government, which could be used to reduce other taxes or for other welfare activities and thus negate the harmful effect of tariffs on consumers to some extent. In the case of a quota being imposed the only beneficiaries would be the importers who are able to get hold of an import license. Secondly, quotas are enforced by allowing imports only against import licenses, which are issued on a selective basis. Since the basis of selection for the grant of import licensees rarely clear, it leaves scope for manipulation, in this aspect, a tariff is better than a quota as it is a more transparent mechanism. Otherwise also importers would prefer facing a tariff rather than a quota, since a tariff would make the availability of the commodity (though at a higher price) a certainty and eliminate the ambiguity involved in a quota system. On the other hand, the local producers for whose benefit the barrier is being put up would rather have a quota in place since it helps them in planning for their future production levels if they can project the future domestic demand. In case of a tariff being in place, the future movements in the world prices and the elasticity of demand foe imported goods would also have to be estimated, which would prove to be a much more difficult exercise.

9.7.15.5 Reasons for Imposition of Trade Barriers

Various arguments have been forwarded to justify the imposition of trade barriers. Some of them may be valid in certain conditions, but most of them are based on

a fundamental misunderstanding of the basic principles underlying international trade. In some cases they only serve to protect the interest of some specific groups in the economy. The various reasons given are as follows:

Tariffs are a source of revenue for the government.

Sometimes compromising on economic welfare becomes essential due to some important national goals. For example, national security cannot be compromised by opening up the defense sector. There may be other national concerns that have to be taken care of, for example, preservation of cultural traditions or environment protection.

The fallacy that a country's economic condition enjoys a trade surplus, tempts governments to put up trade barriers. This line of thinking stems from the period when a nation's wealth used to be measured by the amount of gold it held and may trade surplus or deficit was settled by transfer of gold. This system called the gold standard, no longer works and hence cannot be taken as a reasonable excuse to put up trade barriers. (The system of gold standard is explained in detail in a later chapter.)

Free international trade has a few major implications. The first one is factor price equalization. As international demand for a commodity produced in a particular country grows, the price of the factor of production which is used intensively for that product increases in that particular country. At the same time, demand for the same product produced in other countries reduces, which lowers down the price of that factor in those countries. Hence, the factors of production which are comparatively inefficient suffer in terms of reduced compensation. Another implication in that in the event of an increase in the productivity of one of the factors of production, there is a reduction in the production of goods which intensively use the other factor. These implications give rise to a demand from those sectors for protection of domestic industries, local jobs and the levels of factors prices. These sectors serve as very powerful lobbying groups for putting up trade barriers.

Tariffs are a popular means of retaliation for other countries putting up barriers against domestic goods.

When some foreign producer is found to be dumping some particular good, i.e., selling it at a price that does even cover his costs (this may be done to secure a foothold in the market), anti-dumping duty may be levied.

When some foreign country subsidizes its exports (may be avoid balance of payments Problem), the importing country may impose a countervailing duty.

A nation which is large enough to be able to affect world prices may be able to change the terms of trade in its favor by levying tariffs. Imposition of tariffs would increase the domestic prices beyond the international prices, thus reducing domestic demand. If the domestic demand is large enough, then this fall would induce the world price of that commodity to come down, thus improving the terms of trade for the large country. In this situation, imposition of tariffs could prove to be an attractive proposition for the large country, at least in the short-term. In the long-term, other big countries may also decide to act in the same manner, resulting in a decline in the economic welfare of all countries.

Trade barriers may be needed to protect an infant industry with tremendous growth potential, if it is believed that in the long run it would be able to stand on its own and face international competition. A new industry may not be able to withstand the intense competition from well-developed industries of other countries. However, if it is provided an initial period of shelter, it may be able to develop the economies of scale, the skilled labor force, the technological efficiencies and the product adaptation in accordance with consumer tastes, which are required for turning the comparative advantage in favor. This fact encourages countries to put up trade barriers in that initial period.

Barriers can be used to increase the demand for domestic products (by increasing the price of foreign goods by imposing a tariff or by restricting their availability with the help of quotas), in order to increase the domestic employment

opportunities, especially during periods of recession. This method of generating employment may, however, involve a huge economic cost. The same result may be achieved by following appropriate monetary and fiscal policies. Besides, international trade would cause labor to shift from industries which suffer from comparative disadvantage to those enjoying comparative advantage. This would also result in an improvement in the productivity of labor, thus providing a long-term solution to the problem of unemployment. Restrictive barriers can only provide a short-term solution to the said problem.

Restrictions may be put in place to reduce expenditure in foreign currency by the citizens in order to improve the balance of payments situation.

Helping the exporters build up world markets can be another reason for putting up of t barriers.

Providing encouragement to local production in order to reduce reliance on foi producers serves as a justification for trade barriers

Certain non-tariff barriers (NTBs) like tax breaks for firms producing in certain backward areas of the country (i.e., local production) may be put in place in an attempt to reduce regional income disparities.

Free trade may not be allowed because of the drawbacks of international trade, for e.g.., the unequal distribution of the benefits of international trade among the various sections of the society, short-term unemployment during the transition period from the production of the goods in which the economy is relatively inefficient to those in which it is relatively efficient.

Though a particular industry may not be under any direct threat from advancements in technology in other countries, barriers may still be put in place due to externalities and spillover effects. These terms refer to the phenomenon where a change in technology in a related industry or an outside event changes the comparative advantage of another industry.

Governments may not allow trade with another country due to ideological differences, international sanctions or other political reasons (for example, the US has not traded with Cuba for a long time). Economic sanctions can take a number of forms - from embargo (a complete ban on transactions) to restriction on some particular types of transactions. For example, while in 1990, an embargo was imposed against Iraq due to UN sanctions; in 1998, US banned American entities from entering into some particular transactions with India as a part of sanctions.

Costs of Trade Barriers

Trade barriers have three effects on the economy. First, by increasing the cost of foreign goods and shifting the domestic demand towards domestically produced goods (which are not competitive, implying a higher cost of production), barriers encourage inefficient production by local producers. Secondly, faced with a higher price, consumers reduce the consumption of that good. Lastly tariffs generate revenue for the government. The first two effects have an economic cost involved. Though the third effect does not involve any economic cost, this benefit together with the benefit to the domestic producers cannot offset the economic costs of inefficient production coupled with the reduced consumption and higher prices to be borne by the consumers. So, there is a net loss caused by discouragement to international trade by way of putting up trade barriers.

9.8 REGULATION OF INTERNATIONAL TRADE

During the inter-War period, especially during the Great Depression, various trade restrictions were imposed by countries with the intention of increasing domestic production and output. Bilateral trade substituted multilateral trade. These restrictions, by causing trade wars among various nations, resulted in increased prices and worsened the situation all over the world. This situation continued through the Second World War period. After the second War, as a part of general reconstruction and the restoration of the international system, various institutions were established to promote peace and economic prosperity. The world finally realized that economic development could be brought about only by opening up international trade. The Bretton Woods conference held in 1944 marked the beginning of the new world order. The need for a body to

regulate international trade was felt. This need was addressed by the Havana Charter, adopted in the Conference on Trade and Employment held in Havana in 1948 under the auspices of the United Nations, which provided for the setting up of the International Trade Organization (ITO) as an agency of the United Nations.

Even as deliberations on the Havana Charter were going on, countries felt the need for an immediate reduction of tariffs. The United States of America took the initiative to prepare a document on a general agreement on tariffs and trade. It was followed up by a meeting of 23 countries in Geneva, which came out with an agreement on a set of mutual tariff reductions. This agreement, signed in 1948, came to be known as GATT. It was supposed to be an integral part of ITO never got around to being established. There was a disagreement between the UK and the US over the power of ITO over government actions. Due to this, the US and other countries did not ratify the Charter. The gap created by the non-establishment of ITO was filled by GATT which became the reference point for all international trade. It started serving as a platform where multilateral deliberations over trade policies took place, as well as the forum for settlement of disputes among nations. Around 100 countries became members of GATT, with many more agreeing to abide by its rules.

9.8.1 Objectives of GATT

The GATT charter aimed at improving standards of living through "... substantial reduction of tariffs and other barriers to trade and the elimination of discriminatory treatment in international commerce", i.e., free and fair trade. The basic principles underlying GATT were

1. Countries should work towards progressive liberalization of trade through reduction or elimination of trade barriers. This was sought to be achieved by Article XXVIII of GATT providing for periodical rounds of trade negotiations.
2. Countries should not indulge in discriminatory practices and all trade barriers should be applied on a uniform basis across nations. As an attempt to achieve this, the most-favored-nation (MFN) principle was incorporated in Article I of GATT

requiring that all member nations should accept the MFN clause. This means that a country has to give the same treatment to all other member countries and no country can be given any special treatment. The only exceptional treatment allowed is that provided to all member countries vis-à-vis the non-member countries, or as allowed under other Articles of the agreement. Under this clause, any preferential treatment extended to any one of the member-countries has to be immediately extended to the rest of the members as well. This ensured that any bilaterally negotiated concessions automatically became multilateral in nature. On the other hand, any action taken to protect, a domestic industry had to be applied to all members uniformly. These regulations were put in place in order to ensure that multilateral, rather than bilateral trade, became the norm of the day.

The MFN clause resulted in countries going in for bilateral negotiations on trade liberalization with much more confidence, as they knew that any subsequent agreement with another country entered into by the negotiating trade partner would automatically be available to them. The requirement that tariff reductions, once agreed upon, could not be unilaterally withdrawn, gave a further boost to the confidence.

The national treatment clause, which stated that once foreign goods have entered a country, they cannot be discriminated vis-a-vis equivalent domestic goods and should be subjected to the same taxes and regulations, was also incorporated under the same principle of non- discrimination.

3 Countries should not take unilateral actions against each other. All disputes were to be brought to the notice of, and resolved under GATT through a process of consultations and arbitration.

4 If a country decided to go in for a higher level of tariffs than agreed upon under GATT, it had to compensate the other member countries for the economic loss caused to them.

5 The principle of reciprocity was included for making negotiations more fair. Under this principle, a country receiving a concession had to extend an equivalent concession in return.

6 The principle of transparency prohibited members from using quantitative restrictions like quotas etc. except in a few circumstances allowed under other Articles of the agreement. Quantitative restrictions reduce transparency in two ways. First, if tariffs are imposed, the producers in other countries would know for certain, the price their good would sell for in the country imposing the tariff, and could decide upon the quantity to sell. In case of a quota, there is an ambiguity regarding both the price and the quantity, which went against the principle of transparency. Secondly, while an increase in the price of a foreign good is apparent to the domestic consumer in case of a tariff, the effect of a quota is not clear, which again went against the said principle.

Has the MFN clause been really effective in preventing discrimination between countries? No, it has not. Countries could be discriminated in favour of, or against, even when the letter of the principle of being followed. A country may favour another country by reducing the tariff on those goods which are imported mainly from the second country. Other countries which dp not produce and export those goods would not really benefit from such a concession.

9.8.2 Exceptions to the Basic Principles of GATT

Though the trading rules formed under GATT followed 'the general principles as given above, certain concessions were allowed for countries facing peculiar problems or, for some special situations. Certain actions were permitted under these situations which went against the basic underlying principles, but were seen as essential under the circumstances to maintain the commitment of the members to the treaty. These special circumstances are listed below:

Balance-of-Payments Problems

A country could impose quantitative restrictions in case it was facing severe and continued balance-bf-payments problem; In this situation, the trading partners of that country were not given the option of lodging a complaint or retaliating due to the loss suffered by them.

9.8.3 Regional Groupings

In the post War period, when GATT came into being, great emphasis was being placed on reconstruction of European countries. Countries of that region coming together to forge closer economic ties was seen as a means to achieve this end. This thinking was reflected in the provisions of GATT which allowed for the countries entering into 'free trade area' and 'customs union' agreements. This went against the MFN clause, but was allowed,, the only condition attached being that such groups did not increase the barriers against other countries which did not form a part of their group but were signatories to GATT.

9.8.4 Tariff Preferences

GATT also allowed for the tariff preference systems already in place before the signing of the Agreement to continue, as an exception to the MFN principle. It also approved the Generalized System of Preferences (GSP) under which developed countries could give concessions regarding tariffs on a non-reciprocal basis to LDCs.

9.8.5 Dumping

A country was allowed to discriminate against another country by imposing anti-dumping duty on imports from that country if it was found to be dumping goods. This was allowed under Article VI of GATT. Before a country could retaliate under this provision, it was required to prove that the good was being dumped and that there was a 'material effect' on an established or a growing industry.

9.8.6 The Multi-Fibre Arrangement

The textiles market was characterized by over-supply, both from the developed economies and the developing countries. To overcome this problem, various agreements were entered into bilaterally. These bilateral agreements were later converted into different short-term and long-term multilateral arrangements. As a culmination of these various agreements, the Multi-Fibre Arrangement was signed by 40 signatories in 1974 under the aegis of GATT. This arrangement covered trade in man-made as well as natural fibre, thus effectively taking the whole sector out of the gambit of GATT Under this arrangement, the importing country had the right to impose quotas unilaterally on a country whose exports it perceived to be causing disruptions in the domestic economy. This was a major departure from the basic principles of GATT as it allowed unilateral action, imposition of quotas rather than tariffs and discrimination against countries.

As mentioned earlier, GATT provided for periodical rounds of negotiations. Starting with the Geneva round in 1947, there have been several rounds including the Kennedy Round (1964-67), the Tokyo Round (1973-79) and the Uruguay Round (1986-94). Various issues were dealt with during these rounds of negotiations. Agreements were reached on some of them while others remained unresolved. The end of the Uruguay Round marked the beginning of a new era in international trade by providing for the establishment of a new organization for administering all the agreements reached during the negotiations. The agreement specifying the setting up of the organization called the World Trade.

Organization (WTO), was signed in April 1994 in the Marrakesh Meeting. After being ratified by the necessary number of countries, the agreement for WTO came into effect from January 1, 1995.

The functions for which WTO had been set up were specified in the Article II of the agreement establishing it. Its functions included the implementation, administration and operation of all multilateral trade agreements, administration of the Rules and Procedures governing the Settlement of Disputes and of the Trade Policy Review Mechanism, and it provided a forum for further discussions between member countries

on matters relating to multilateral trade as well as for implementation for the results of such negotiations. One of the important differences between GATT and WTO was that the latter allows cross-retaliation, i.e., a country can retaliate by reducing concessions in a sector different from the one in which it has grievances. This increases the bargaining power of the developed nations to a great extent. Further, a specific time frame has been laid down for completion of various negotiations for the purpose of speeding up the process. The negotiations would now continue on a perpetual basis rather than depending upon rounds.

There were some other important outcomes of the Uruguay Round. While trade in agriculture was liberalized, the developed countries agreed to cut the average tariff levels on industrial goods by 40 percent over a five year time frame. The developing countries also agreed to raise their imports covered by "bound tariff" (which cannot be raised) from 13 to 61 percent. It was decided that the trade in textiles and clothing (which was earlier covered by Multi-Fibre Arrangement) would be brought gradually under the gambit of WTO. The quotas under the Arrangement are set to be phased out by 2005. However, the phase-out would be "back loaded", i.e., about two-thirds of the quotas would go only after 2002. In the area of services, an agreement called GATS (General Agreement of Trade and Services) was arrived at. This agreement promotes the principles of transparency and multilateralism by making compulsory the publication of the relevant laws and regulations (thus **removing ambiguity), the** liberalization of rules on international payments and non-discrimination in recognition of qualification of service providers. In addition, new areas like Trade-Related Intellectual Property Rights (TRIPS) arid Trade-Related Investment Measures (TRIMS) now came under the discipline of WTO.

GATT was just a set of rules arrived at by multilateral agreement which were neither permanent nor strictly binding, and lacked the institutional framework. AS a contrast, WTO is a permanent institution and any declaration adopted on its floor regarding the general ground rules for international trade would be permanent and binding on all nations. In addition, WTO is to serve as the authority to settle trade

disputes between countries. It has the authority to enforce sanctions against nations violating the rules.

Under the new trade dispute settlement system, the WTO Ministerial meet is the highest authority which is required to meet once every two years to decide on all matters relating to trade agreements. The first Ministerial meet took place between December 9 and 13, 1996. The major issues discussed there were labor standards, investments and competition policy. Another area looked into was government procurement. A major achievement of this meeting was the pact on Information Technology. This pact requires the signatories to completely eliminate tariffs on all IT products by 2000 A.D. 28 countries who control about 85 percent of the world trade in IT signed the pact. India was not among them. The second Ministerial meet took place in May, 1998. On its agenda were further implementation of the existing agreements (including review of the difficulties being faced by countries trying to implement them) and further broadening the agreements on the basis of reciprocity). Nothing substantial came out of this round.

There is another international agency looking after multilateral trade. It is called the United National Conference on Trade and Development (UNCTAD). It is a part of the UN umbrella and was formed at the instance of the developing countries in 1964. Though the achievements of this institution have not been top many, it gave world trade an important agreement called the Generalized System of Tariff Preferences (GSTP). Under this system, the developed countries are expected to give preferential treatment to imports from less-developed countries by way of lower rates of tariffs, without reciprocal action on the LDC's part. This arrangement was entered into with a view to promote industrialization of the LDC's. Apart from this, UNCTAD has not been able to contribute anything substantial to the development of world trade.

9.9 MERGERS AND ACQUISITIONS

Mergers and acquisitions (M & A) have been a very important market entry as well as expansion strategy.

A number of Indian companies have also used this entry strategy. For example, as noted under the section on „Growth Opportunities" Indian companies made a big foray into Germany by acquisition.

Mergers and acquisition have certain specific advantages.

They provide instant access to markets and distribution network. As distribution is one of the most difficult areas in international marketing, this is often a very important consideration for M & A. Vijay Mallya's United Breweries, India's largest brewing and distilling group, acquired a small British company, Wiltshire Brewery. Wiltshire's attractiveness for UB lay in the fact the former offers a readymade chain of pubs throughout England which could be used for the marketing of UB's beer brands like Kingfisher, UB Larger and Kalyaniin the UK.

Some years ago, the General Electric (GE), USA, took over Hungary's light bulb maker Tungsram. Instead of starting a Greenfield operation in Hungary by building a new factory and hiring the people needed, why the multinational giant take did over Tungsram, a typical Hungarian enterprise bogged down with so many problems calling entry to the East European light bulb market, from which it has been virtually excluded by Philips and Osram. Tungsram's share of the market in the 1980s was a respectable 9 to 10 per cent.

Another important objective of M & A is to obtain access to new technology or a patent right. M & A also has the advantage of reducing the competition.

Mergers and acquisitions may also give rise to some problem which arises mostly because of the deficiencies of evaluation of the case for acquisition. Sometimes the cost of acquisition may be unrealistically high. Further, when an enterprise is take over, all its problems are also acquired with it. The success of the enterprise will naturally depend on the success in solving the problems.

It has also been observed that the takeover spree lands several companies in trouble. For example, in the early 1990s, a number of Japanese companies began to sell some of the foreign business which they had acquired a few years ago. The main reason for this was the financial crunch.

9.10 STRATEGIC ALLIANCE

NOTES

Strategic alliance has been becoming more and more popular in international business. Also known by such names as *entente* and coalition, this strategy seeks to enhance the long term competitive advantage of the firm by forming alliances with its competitors, existing or potential in critical areas, instead of competing with each other. "The goals are to leverage critical capabilities, increase the flow of innovation and increase flexibility in responding to market and technological changes."

Strategic alliance is also sometimes used as a market entry strategy. For example, a firm may enter a foreign market by forming an alliance with a firm in a foreign market for marketing or distributing the formers products. A US pharmaceutical form may use the sales promotion and distribution infrastructure of a Japanese pharmaceutical firm to sell its products in Japan. In return, the Japanese firm can use the same strategy for the sale of its products in the US market.

Strategic alliance, more than an entry strategy, is a competitive strategy.

Strategic alliance which enables companies to increase resource productivity and profitability by avoiding unnecessary fragmentation of resources and duplication of investment and effort are growing in popularity and are very conspicuous in such industries as pharmaceuticals, computer, nuclear, telematics etc., which are characterized by high fixed costs in R&D and manufacturing and/ or high and fast-changing technology.

Kenichi Qhmae, the author of The Mind of the Strategist in his HBR article on 'The Global Logic of Strategic Alliance' argues that in a changeable world of rapidly globalizing markets and industries - a world of converging consumer tastes, rapidly spreading technology, escalating tool for serving customers. According to him, globalization mandates alliance and makes them absolutely essential to strategy.

It has been pointed out that as the business environment, both locally and internationally, becomes increasingly competitive, companies will have more reasons, and will find more ways, to form strategic alliances. As that happens, strategic alliances

will not only be a logical alternative but a key to survival in business. Management experts predict that in the not-too-distant future, alliances will be a necessity not only of individual companies but also for orderly development of entire industries and that company in mature, slow-growth industries will increasingly look to strategic alliances for survival.

There are different types of alliances according to purpose or structure. Based on the description of the generic forms of coalitions by Micheal Porter and Mark Fuller, Magsayasy classifies alliances according to purpose as follows.

1. Technology development alliance like research consortia, simultaneous engineering agreements, licensing or joint development agreements.

2. Marketing sales and service alliances in which a company makes use of the marketing infrastructure, etc., of another company, in the foreign market for its products. This may help easy penetration of the foreign market and pre-emption of potential competitors.

3. Multiple activity alliance which involves the combining of two or more types of alliances. While marketing alliances are often single-country alliances, as international firms take on different allies in each country; technology development and operations alliances are usually multi-country since these kinds of activities can be employed over several countries.

Strategic alliances also differ according to how they are structured. They can be equity based (joint ventures) or non-equity based. Non-equity based alliances Such as technology transfer agreements/licensing agreements, marketing agreements etc., are proving to be more dynamic more constructive and more strategic, according to Magsaysay.

As indicated above, several areas of business-from R&D to distribution-provide scope for alliance. Whether it is in R&D, manufacturing or marketing, an important objective of the collaboration is to minimize marginal contribution to fixed cost. Thus, as Ohmae points out, in the pharmaceutical industry, where both ends of the business system (R&D and

distribution) represent unusually high fixed costs; potential competitors swap their products for distribution in the respective markets where they have well established distribution systems. In particular, several such alliances exist between Japanese and US pharmaceutical firms.

In the semiconductor industry, most companies in the US and Japan feel short-handed in their R&D, and hence, they swap licenses aggressively. In a multiple alliance that covers technology and operations. Samsung Electronics Co. and IBM Korea Inc. have agreed to swap patents in the design and manufacture of semiconductors. Apple Computer and IBM have formed an alliance for the development of software and hardware technology for a new generation of desktop computers. Similarly, various firms have promoted co-operative arrangements in the nuclear industry.

Examples of cross-border alliances in the telematics sector which essentially bring together two separate streams of technology-that related to information gathering and processing and that related to information transmission-include IBM's agreements with STET, Italy's state owned telecommunications company and Nippon Telegraph and Telephone (Japan) to develop computer communications services, and a joint research venture with Ericsson (Sweden) to explore the linking of data- management technology with digital switching technology.

The automobile industry has been witnessing several alliances overseas operations. The Isuzu Motors Ltd and Fuji Heavy Industries Ltd of Japan have set up a joint plant in the US which can build cars for Fuji and trucks for Isuzu on the same auto line. Some Japanese automakers have joined forces with foreign big names like General Motors and Chrysler. The European car manufacturers are also teaming up to enhance their competitiveness, often in one-off projects to produce, say, a transmission engine. Peugeot, Renault and Volvo already share the V 6 engine.

According to an alliance between Tatas and TFR, a leading French leather finisher and European marketer, Tatas will integrate its production with the exact colour, texture and other requirements of large European buyers, while TFR will provide the

existing marketing network, links to key buyers, its name and reputation, and knowledge of the latest fashion trends.

Tata Tea has entered into an alliance with Tetley so that the marketing expertise of Tetley is available to market tea abroad.

Explaining international production, Dunning observes that within the service sector, strategic alliances are less common, but those between hotels, airlines and tour operators, and between accountants and management consultants are increasing; while international consortia of investment banking and construction firms have long been a feature of the world commercial scenario.

6 _____ refers to direct exchange of goods of equal value, with no money and no third party involved

9.10.1 Counter trade

Although the major reason for the substantial growth of counter trade is its use as a strategy to increase export, particularly by the developing countries, counter trade has been successfully used by a number of companies as an entry strategy. For example, PepsiCo gained entry to the USSR by employing this strategy.

Counter trade is a form of international trade in which certain export and import transactions are directly linked with each other and in which import of goods are paid for by export of goods, instead of money payments.

In the modern economies, most transactions involve monetary payments and receipts, either immediate or deferred. Against this "counter trade refers to a variety of unconventional international trade practices which links exchange of goods-directly or indirectly-in an attempt to dispense with currency transactions."

9.10.2 Forms of Countertrade

Countertrade takes several forms. The following are the most common among them.

Barter:

Barter refers to direct exchange of goods of equal value, with no money and no third party involved. For example, a countertrade deal between the Minerals and Metals Trading Corporation of India (MMTC) and a Yugoslavian company involved import of 50,000 tonnes of rails of the value of about $38 million by the MMTC and the purchase by the Yugoslavian company of iron ore concentrates and pellets of the same value.

9.10.3 Buy Back

Under the buy back agreement, the supplier of plant, equipment or technology agrees to purchase goods manufactured with that equipment, or technology. Under the buy back scheme, the full payment may be made in kind or part may be made in kind and the balance in cash. Thus, a Rs. 20 crore buy back agreement with the Soviet Union provided for the import of 200 sophisticated looms by the National Textiles Corporation. The buy back ratio was 75 per cent.

Compensation Deal

Under this arrangement, the seller receives a part of the payment in cash and the rest in products.

9.10.4 Counter purchase

Under the counter purchase agreement, the seller receives the full payment in cash but agrees to spend an equivalent amount of money in that country with in a specified period. A classic example of this kind of an agreement was Pepsi cola"s trade with the USSR; Pepsi got paid in rubles for the sale of its concentrates in the USSR but spent this amount for purchase of Russian products like Vodka and wine.

The array of counter trade transactions reported in the trade press is intriguing. Coca-Cola has traded its syrup for cheese from a factory it built in the Soviet Union, for oranges from an orchard it planted in Egypt, for tomato paste from a plant it installed in Turkey, for Polish beer, and for soft drink bottles from Hungary. A Swedish brand was

paid in coal for its concerts in Poland. Boeing exchanged ten 747s for 34 million barrels of Saudi Arabian oil. Argentina awarded a fertilizer factory contract to Czechoslovakian firms with the stipulation that suppliers buy vegetables and other agricultural goods produced with fertilizers.

Many countertrade deals involve more than two parties and the process becomes complex and intricate. If the seller can get in exchange from the buyer the products which he wants, or for which he has a ready market, the counter trade deal would be very smooth. However, in several cases the buyer will not be in a position to offer in exchange-goods which the seller really needs. In such cases, it may become necessary, for the deal to be struck, for the seller to accept the products the buyer can offer and hunt for buyers for such products. Kolter, for example, cites a very interesting case; Daimler Benz agreed to sell thirty trucks to Romania and accept in exchange 150 Romanian made jeeps, which it sold in Ecuador in exchange for bananas which it brought back to West Germany and sold to a-West German supermarket chain in exchange for deutschmarks. Through this circuitous transaction, it finally achieved payment in German currency.

Such complexities involved in many counter trade deals have provided an important role to the international trading houses in such transactions; The insurmountable problem of finding suitable goods in return by the exporters "has redefined the importance in Japan of the trading houses" and "Japan's nine major general trading houses have all now established divisions specifically to research counter trade opportunities. "Counter deals were used by the Japanese trading houses as a means to boost their business with hard currency strapped China and the former USSR. These trading houses can take massive and complex counter trade deals "in their strides as they posses expertise in almost every field, practice every conceivable trading pattern, and can mobilise everything from staff to technology to finance. In addition, most are under the umbrellas of Zaibatsu that include powerful banks and/or construction firms. As if this were not enough, the trading houses are prepared to join forces with each other if necessary under the auspices of the awesome Nihon Boekikai, the body they set up themselves for the handling of joint ventures.

9.10.5 Growth of Counter trade

A significant volume of international trade is covered by countertrade. Countertrade, of course, is not a new phenomenon but the nineteen seventies and eighties witnessed a remarkable growth in this type of international trade, encouraged by many governments and actively pursued many trading houses, both private and public, although organization like GATT (WTO) AND IMF do not favor it.

According to one report, the number of countries practicing countertrade increased from 27 in 1973 to more than 90 by mid-1980s. A study by the US Department of Commerce found that countertrade covered 38 percent of East-West trade in 1981 compared with 28 per cent in 1976. According to the estimates made by the Economist quite some time ago, countertrade accounted for one-fourth of all world trade. However, the GATT in a report had noted in 1983 that countertrade accounted for about 8 per cent of global trade. A-source in the US Department of commerce expected some time ago that countertrade would be reflected, in one way or the other, in 50 per cent of the world trade by the end of the twentieth current century. The political and economic changes in the former USSR and Eastern Europe do not appear to adversely affect the growth of countertrade.

Countertrade has been growing with government patronage. According to one report, more than 81 countries across the world had actual pro-countertrade government policies. Countertrade has been made mandatory by a number of countries including Indonesia, South Korea, Malaysia, and Australia in case of government/public sector purchases of above certain specified value. Even though a number of other countries like Bangladesh, Burma, China, Pakistan, Philippines, all encourage their importers to settle transactions on countertrade basis. Indian public sector agencies like STC and MMTC are active in countertrade. Government of India set up a special cell in the Ministry of Commerce to monitor international developments in countertrade and to develop appropriate policy to enable Indian canalizing agencies to make best use of opportunities available to boost India's exports through countertrade.

It may be noted that the South Commission has advocated countertrade as a useful mechanism for overcoming difficulties of payments, export credit, and foreign exchange which otherwise be serious obstacles to the expansion of trade between developing countries. As the commission points out, so far the bulk of countertrade between developing countries has been conducted mostly through intermediaries in the industrial countries. It is the developed countries who have benefited most from this type of trade, and they obviously have no interest in helping the indirect trading partners in the LDCs to establish direct contacts and develop durable trading relationships. Therefore, the developing countries need to organize themselves for countertrade as this can also pave the way for the growth of more conventional trading relations.

9.10.6 Reasons for the growth of Countertrade

There have been several reasons for the countertrade to become popular. Obviously, the countries or companies concerned have encouraged or increasingly involved themselves in countertrade due to certain specific advantages, although some of the benefits may be purely temporary.

i. Countertrade was very common between the Communist countries. It also became popular in trade between the Communist block and many developing countries because many developing countries were eagerly looking towards this block for increasing their exports, among other things, and this naturally led to the acceptance of the acceptance of the trade practice preferred by these centrally planned economies.

ii. Countertrade became popular in the East-West trade mainly due to the foreign exchange problems faced by the East Block.. Pepsi Cola is just one example of a multinational corporation which made considerable international business with the USSR by countertrade.

iii. When the foreign exchange problem became more severe for the developing countries following the oil price hikes, they began to actively pursue countertrade in a frantic bid to increase their exports by all means.

iv. Many companies in the advanced countries have resorted to countertrade for various reasons like selling obsolete products, increasing the sale of capital goods, increasing aggregate business, etc.. Countertrade has also been resorted to by several companies to mitigate the effect of recession. Such recessionary situations in the capital goods industries in the advanced countries gave the developing countries an opportunity to push their exports by tying the imports of capital goods with exports by countertrade.

v. The results of a survey of 35 British companies involved in international countertrade by Shipley and Neale accorded with the descriptive literature in so far as the Eastern Bloc countries were the main group of countertrade customers, reflecting their acute currency and international debt problems. Nevertheless, substantial portions of the firm"s con- ducted countertrade in the world's less developed regions while there was some limited support for the claims that developed nation"s counter trade among themselves.

vi. The result of this survey also suggests that counter trade enables firms to penetrate difficult markets, to increase sales volume and to achieve fuller capacity utilization. It has also been revealed that counter trade enables firms to dispose of declining products, which is particularly important given the very rapid pace of technological advance. Thirty- seven per cent of the companies surveyed reported this benefit.

vii. Some countries have also made counter trade a means to increase sales through disguised undercutting of the cartel prices (for example, the oil price fixed by the OPEC).

viii. Having realized the potential of increasing the business by engaging in countertrade, many international trading corporations became active in the countertrade. Their trading with many countries enabled them even to take up such complex transactions as the case of Daimler Benz cited earlier.

It may be noted here that,

9.10.7 Drawbacks

After the reintegration of the erstwhile Soviet Union, when the Government of India has been finding it difficult to establish two-way trade flows, the Pepsi Foods

Private Ltd made an attractive offer to the Government to enter into counter trade deals with individual enterprises in the commonwealth of Independent States to import the much needed oil, non-ferrous metals, fertilizers and newsprint. Although countertrade has several justifications, particularly in the short run, it suffers from a number of disadvantages and problems, particularly in the long run.

First, countertrade encourages bilateralism at, the expense of multilateralism.

Secondly, it adversely affects export market development.

Thirdly, although several developing countries regard countertrade as an easy route to export, they often stand to lose in terms of price.

Fourthly, it very adversely affects competition.

9.11 SUMMARY

World trade has grown rapidly in the last few decades. These latest developments can be reasonably expected to make it grow at an even faster rate. Whether the benefits of this growth are being usurped by a few developed nations due to the political and economic power enjoyed by them, is a hotly debated topic which is unlikely to be settled in the near future. The only thing which is certain is that the world as a whole is going to tremendously benefit by this coming together of nations in an attempt to sort out their differences and to find a mutually benefiting solution to the various problems facing them.

9.12 KEY WORDS USED IN THE LESSON

Absolute advantage Theory

Trade and Tariff barriers

Perfect Competition

GATT

Countertrade

Merger and Acquisition

Strategic Alliance

Theory of Competitive advantage

9.14 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1 Adam Smith

.2 1817

3 Two

4 Technological innovation, Market Structure

.5 Association of South East Asian Nations

6 Barter

9.15 Model Questions

1. Bring out the limitations of theory of Absolute advantage.
2. What is meant by Perfect Competition?
3. Bring out the risks involved in International Trade.
4. What are the different forms of Trading Blocks?
5. Write a short notes on Trade and Tariff Barriers.
6. Bring out the different purposes of Strategic Alliance in International Trade.

Essay Questions:

1. Explain the major assumptions of Theory of Competitive Advantage.
2. Explain in detail about Heckscher Ohlin Model.
3. Discuss the contribution of International Product Lifecycle Theory in International Trade.
4. What are the reasons for Imposition of Trade barriers?
5. Discuss the objectives and principles of GATT.
6. State the advantages of M&A.
7. What are the various measures considered in Counter trade?

9.13 Further reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

UNIT-X

INTERNATIONAL TRADE FINANCE IN INDIA

UNIT STRUCTURE

10.1 Introduction

10.2 Unit Objectives

10.3. Import Financing

10.4 Export Financing

10.5. Guarantee

10.6 Summary

10.7 Key words used in the lesson

10.8 Answers to check your progress questions

10.9 Model Questions

10.10 Further reading

10.1 INTRODUCTION

International trade is important for all countries as it increases the overall efficiencies of world production. The significance of international trade has resulted in the supporting activities assuming their own importance. The most important supporting activity is that of financing international trade. Financing of international trade takes two forms - financing imports and financing exports.

10.2 OBJECTIVES

To study the types of Letters of Credit

To identify the Facilities available for Export Finance

To know the role of EXIM Bank

To understand the related RBI Regulations in international trade

10.3 IMPORT FINANCING

NOTES

The major way in which imports are financed is through letters of credit. It is an important document which facilitates financing.

10.3.1 Letter of Credit

A letter of credit is defined as "an arrangement by means of which bank acting at the request of a customer, undertakes to pay to a third party a predetermined amount by a given date, according to agreed stipulations and against presentation of stipulated documents".

Parties to Letters of Credit

There are four parties to a letter of credit. These are

Applicant (or opener): It is the importer who approaches the bank for opening a letter of credit.

Issuing bank: It is the bank which opens the letter of credit.

Beneficiary: It is the exporter in whose favor the letter of credit is opened.

Advising bank: It is the bank which informs the exporter about the letter of credit being opened, at the behest of the issuing bank. It is generally based in the-same place as the exporter.

10.3.2 Types of Letters of Credit

Letters of Credit are classified into various categories on the basis of their features. This classification, given below, is not mutually exclusive.

Check Your Progress

1 A Letter of Credit is one which can be cancelled or revoked by the issuing bank at the request of the applicant, without the consent of the beneficiary, can be called as___.

Revocable Letter of Credit: A revocable Letter of Credit is one which can be cancelled or revoked by the issuing bank at the request of the applicant, without the consent of the beneficiary.

Irrevocable Letter of Credit: An irrevocable Letter of Credit is one which cannot be canceled by the issuing bank without the consent of the beneficiary.

Deferred Payment Letter of Credit: It is a Letter of Credit that allows the issuing bank to make the payment to the beneficiary in installments. The timing and the amounts of these installments are predetermined.

Confirmed Letter of Credit: A letter of credit that is confirmed or guaranteed by a bank in addition to the issuing bank is referred to as a confirmed Letter of Credit.

Unconfirmed Letter of Credit: When a letter of credit is not confirmed by any bank other than the issuing bank, it is called an unconfirmed letter of credit.

Revolving Letter of Credit: A letter of credit whereby the credit available to the beneficiary gets reinstated after being utilized once is referred to as a revolving credit. A revolving credit may be limited by the overall credit available, or the time period in which such credit may be utilized, or both.

Transferable Letter of Credit: A transferable letter of credit is one where the beneficiary can transfer his rights to a third party. The third party is usually the manufacturer of the goods utilizing the services of the beneficiary as a marketer or a middleman.

Back-to-Back Letter of Credit: A back-to-back credit or a countervailing credit is a letter of credit which is opened with another letter of credit as the security. The letter of credit acting as the security is known as the overriding or principal credit. This letter of credit may be opened by a middleman in favor of the actual producer or supplier of goods, on the security of the letter of credit opened by the importer quoting him as the beneficiary. A back-to-back letter of credit may be opened be the beneficiary when he

does not want to reveal the identity of the producer from the importer or when the importer does not want to open a transferable letter of credit.

Anticipatory Letter of Credit: It is a letter of credit under which payment is made to the beneficiary even at the pre-shipment stage. There are two kinds of anticipatory letters of credit. Under the red clause credit, advance is given for purchase of raw material processing and/or packing of goods. Under the green clause credit, advance is also given for warehousing and insurance charges at port.

Check Your Progress

2. Back-to-back credit is other wise called as _____.

10.4 EXPORT FINANCING

Exporters are a subject of significance to every economy whether developing or developed because they represent the biggest source for earning foreign exchange. The need is all the more acute for a developing economy, which mostly experiences deficit on current account as well as capital account. Attempts to create capital account surplus are also desirable yet the finds that come in shall remain under the ownership of the non-residents. However, surplus on current account represents earning by residents and thus the ownership rests with residents; while there are exceptions to what is stated above it is quite common for countries to take steps to encourage exports in the larger interest of the economy. It is no different in lndia. Government of India provides incentives either directly or indirectly to exporters for undertaking their normal business activities. Such incentives include the following:

Cash incentives for certain exports

Concessional interest rates on export credit

Lower duties on imports which are required for exports

Tax concessions

Infrastructure facilities.

Commercial banks play a vital role in this process since they become channels in this process in one form or the other. As in the case of any business commercial banks

are predominantly involved in extending working capital finance to the exporters. The export credit sanctioned is classified into two categories depending on the timing of the credit.

Pre-shipment Credit

Post-shipment Credit

10.4.1 Pre-shipment Credit

The purpose of this credit is to provide the necessary funds to the exporter to procure raw material and meet the costs involved in manufacturing the goods. This credit may be initially extended without any security in which case it is known as extended packing credit. At" this stage it remains a clean advance. The funds so lent are to procure the raw material, which then is charged to the bank. Then the advance becomes a secured advance. The advance is given either in the form of a loan or in the form of an operating account. The advance so given has to be adjusted with the proceeds of the export. Hence it is necessary to ensure that the loan given for executing a particular export order of adjusted out of the sale proceeds of that export. However the banker is vested with the authority by RBI to waive this condition and to allow the advance to be adjusted from the proceeds of any export transaction.

Check Your Progress

3 Pre-shipment credit may be initially extended without any security is known as _____.

Pre-shipment credit is extended for the period which matches with the operating cycle of the activity. However, the period of credit is normally restricted ti a maximum of 180 days. It is envisaged that the export will be materialized within the due date and the loan will be adjusted from the export proceeds. However, the banks have the discretion to extend the period of credit up to360 days under special circumstances. In order to ensure that export will materialize, banks normally insist for a Letter of Credit opened in the name of the exporter or a confirmed order before reloading the pre-shipment credit.

10.4.2 Post-shipment Credit

Once the goods are exported there will be a time lag between the time of export and the receipt of the payment from the importer. This time depends on the transit time and the credit period extended by the exporter if any. The banks extend finance during this is usually in the form of finance extended against documents (Bill Finance). The documents presented along with the bill should conform to the terms and conditions of the Letter of Credit, which normally accompanies an export transaction.

Advance against Cash Incentives

In order to encourage exports the Government of India extends certain cash incentives to the exporters so that exporting becomes more competitive than selling in the domestic market. Once the export is complete the government releases the amount of cash incentive. In such instances the commercial banks extend credit to the exporter in anticipation of the receipt of cash incentive. The advance may be extended either at pre-shipment stage or at post-shipment stage.

Deferred Payment Exports

Generally, export proceeds are to be realized within a period of six months from the date of shipment; where payment extends beyond this period, it is known as deferred payment contract. Payment will be made by the importer over a period in installments.

Deferred payment contracts are allowed with the prior approval of RBI.

10.4.3 Turnkey Projects

Turnkey projects are those requiring the rendering of services like civil construction, design, erection and commissioning of plants, supervision thereof and supply of equipment for the plant. Both deferred payment exports and turnkey projects require various guarantees. Commercial banks execute guarantees on bid bond, performance, advance payment, retention of money after seeking approval of the EXIM

bank. For large contracts, EXIM bank may also participate with the bank in issuing guarantees.

Bank guarantee is an undertaking by the issuing bank to the importer or the importer's bank or the government of the importer's country that in the eventuality of the exporter not fulfilling the conditions of the contract, the bank would compensate them for the loss subject to the maximum amount specified in the guarantee.

Duty Drawback Credit Scheme, 1976

Under this scheme, exporters who were entitled to Duty drawback incentives under the EXIM Policy in force for exports affected by them could avail interest free advances from the Bank, provided they submitted Provisional Duty Drawback Entitlement Certificate issued by the Customs authorities.

The RBI in turn refinanced the banks for extending small advances, free of interest. But, as all refinance facilities, excepting exports refinance, were withdrawn with effect from October 9, 1991), and as the Government abolished some of the export incentives, the facility of interest free .advances' to the exporters under the Duty Drawback Credit Scheme also stood withdrawn. Exporters however, ' continue to be eligible for advances from banks against duty drawback and other incentives receivable from the Government covered by ECGC guarantee.

Check Your Progress

4 The project which requires the rendering of services like civil construction, design, erection and commissioning of plants, supervision thereof and supply of equipment for the plant, known as _____.

10.4.4 The Role of Export-Import Bank of India (EXIM) in Trade Finance

The EXIM bank was set up to finance and promote foreign trade. EXIM bank extends finance to exporters of capital and manufactured goods, exporters of software and consultancy services and to overseas joint ventures and turnkey/construction projects abroad. Term loans are also extended to projects located in export zones.

EXIM bank financing can, if required, supplement working capital finance extended by commercial banks at pre-shipment stage. The functions of the EXIM bank are lending, promotional services and advisory services.

Lending

No	I. To Indian Companies	II. To Foreign Govt. Foreign Companies	III. To Indian Banks
1	Direct Assistance	Buyer"s Credit	Bill Rediscounting
2	Consultancy and Technology	Lines of Credit	Refinance
3	Overseas Investment		Relending Facility
4	Pre-shipment Credit		
5	Deemed Exports		
6	100% Export Oriented Units and Free Trade Zones		
7	Forfaiting		

10.4.4.1 Lending to Indian Companies

Direct Assistance

Funds are provided on deferred payment terms to Indian exporters of plant, equipment and related services, which enable them to extend deferred credit to the overseas buyer. Credit is provided by EXIM bank in participation with commercial banks. Banks provide the credit and they can avail of refinance from the EXIM bank. The exporter is expected to obtain an advance and a down payment of at least 15 percent of the contract value.

Consultancy and Technology Services

Indian companies executing overseas contract involving consultancy and technology Services, can avail of EXIM's financing program, to offer deferred payment terms to their clients. The credit may be extended to the Indian company either by EXIM bank in participation with commercial banks, or directly by commercial banks who could

in turn seek refinance from EXIM bank. The Indian company in turn would offer deferred payment terms to their clients.

The credit normally given in Indian rupees is repayable in half-yearly installments over a period not exceeding five years. Guarantee of foreign Government or a guarantee/irrevocable LC of an acceptable bank would need to be obtained. The Indian company also has to obtain ECGC insurance cover and assign it in favor of the bank.

10.4.4.2 Overseas Investment Finance

The EXIM bank provides export credits to Indian promoters for their equity contribution to overseas joint ventures. The funds are in the form of long-term credit not exceeding ten years. EXIM bank's finance will be made available to Indian promoters by way of

1. Rupee term loans for financing equity contribution.
2. Foreign currency loans/guarantees, where the equity contribution is allowed by the Government of India out of foreign currency loan to be raised by the Indian promoter.

Equity contribution by Indian promoters can be in various forms such as

a. Capitalization of proceeds of exports in the form of plant and machinery.

b. Technical know-how.

c. Capitalization of earnings such as royalty and management fees.

d. Cash remittances.

Where cash remittances are allowed, Indian promoters are granted approvals to remit foreign exchange from India or raise foreign currency loans for the purpose of equity contribution.

The quantum of finance will be determined with reference to the Indian promoter's share in the equity structure of overseas joint ventures, subject to a maximum of 80 percent of the Indian promoter's equity contribution. Commercial banks may also opt to take up risk participation in term loans and guarantees extended by EXIM bank.

Pre-shipment Credit

If the requirement of pre-shipment credit by exporters is for periods in excess of 180 days, EXIM bank participates in the credit.

Financing Deemed Exports

Deemed exports occur in case of specified transactions within India, which result in foreign exchange earnings or saving as given below:

i. Supplies made in India to World Bank/DA-aided projects against international competitive bidding

ii. Supplies to free-trade zones/100 percent export oriented units

iii. Sales to foreign to foreign shipping companies and. Supplies to ONGC and Oil India Ltd., for offshore and onshore drilling operations.

Deemed exports can avail of EXIM banks deferred credit facility. EXIM bank may participate with commercial banks in extending rupee loans for bridging cash flow deficits of projects/supply contracts; EXIM bank also issues guarantees and provides bridge finance in foreign currency.

Capital and producer goods are eligible for medium-term credits. Long-term credits up to ten years are provided in exceptional cases. Credit is normally secured by a bank guarantee.

10.4.4.3 Assistance to Export-oriented Units

Free-trade zones and export-oriented units are given finance for acquisition of land, building, plant and machinery, preliminary and pre-operative expenses and working

capital (as margin money), EXIM bank's assistance will be in the form of direct assistance given as rupee term loans or deferred payment guarantees or indirect assistance as refinance to commercial banks. Direct assistance will be extended op its own or in participation with commercial banks/term lending institutions in respect of projects with cost above Rs. 2 crore. Re-finance will be available for projects with cost up to Rs. 2 crore.

Repayment period (not exceeding ten years) of the term loans will be determined on the basis of projected cash flow. Promoters" contribution will have to be a minimum of 20 percent of project cost; EXIM bank also requires a debt-equity ratio of 1.5. 1, relax able on merits. The export-oriented units seeking EXIM's finance will have to establish the technical, economic and financial feasibility of their projects.

Forfaiting

Forfeiting is a common form of financing export related receivables. It is similar to Bill Rediscounting Scheme. EXIM Bank has introduced this scheme for the Indian exporters. Under this scheme, the exporter after finalization of the sale (or contract) with a prospective buyer furnishes all the necessary details regarding the contract to the EXIM Bank through which a contract of forfaiting is finalized by the exporter with the overseas forfeiting agency. The exporters draw a series of bills of exchange on the overseas buyers' which will be sent along with the shipping documents to the buyer's bank for overseas buyer's acceptance. Overseas buyer's bankers will hand over to the exporter the document of „aval" or the guaranteeing bank. The exporter will submit to his bank to be forwarded to EXIM Bank which passes the documents to the forfaiting agency. Proceeds of the bills are passed from the overseas forfaiting agency to the exporter through the EXIM Bank. From October 1997, the authorized dealers are allowed to undertake forfaiting of medium-term export receivables.

10.4.4.5 Lending to Foreign Governments and Foreign Companies: Buyers' Credit is given to buyers abroad to enable them to import engineering goods from India on deferred payment terms. The loan facility is to be secured-by a letter of credit or a bank guarantee.

Lines of Credit

EXIM bank also extends lines of credit to overseas governments or agencies nominated by them, to enable buyers in these countries to import/engineering goods from India on deferred payment terms. The exporters can obtain payment from EXIM bank against negotiation of shipping documents.

10.4.5 Relending

An overseas bank can enter into a credit line agreement with EXIM bank. The overseas bank would relend the funds to importers of capital goods, consumer durables and services from India. The borrowing bank may be a commercial bank, a central bank, an investment/merchant bank with a good credit standing. The credit line limit for each bank would normally be $5 mn to $10 mn and may be raised to $15 mn. If justified. The loan amount would be up to 95 percent of contract value.

Loans will be denominated in U.S. dollars and repayment will also be in the same currency. Short-term loans extending from 180 days to one year are repayable by quarterly/half-yearly installments. Medium-term loans are also given.

The relending facility will operate as follows:

a. The borrowing bank, upon its approval of a sub-loan to an importer, opens irrevocable letters of credit in favor of the Indian exporter through EXIM bank or banks designated by the latter.

b. The Indian exporter ships goods and presents shipping documents to EXIM bank or banks designated by the latter.

c. EXIM bank pays to the Indian exporter the rupee equivalent.

d. EXIM bank or the negotiating bank in India forwards shipping documents to the borrowing bank, together with the advice of having made disbursement to the supplier.

10.4.6 Lending to Indian Banks

10.4.6.1 Rediscounting of Export Bills

Commercial banks that are authorized dealers can rediscount their short-term usance export bills with EXIM bank.

10.4.6.2 Refinance for Deferred Payment Exports

Deferred payment exports arise when export proceeds are to be received after six months from the date of shipment EXIM bank offers hundred percent refinance facility to banks, which enables a bank to extend deferred credit to an Indian exporter against supplier's credit offered by the exporter to the overseas buyer. Capital goods, consumer durables and industrial manufactures can be considered for deferred credit. Commercial banks can entertain deferred credit contracts valued up to Rs.2 crore and avail refinance from EXIM bank. Contracts above Rs. 2 crore attract participation finance from EXIM bank.

EXIM bank refinance is made available in Indian rupees. The exporter is expected to obtain advance/ down payment of at least 10 percent of the contract value.

10.5 GUARANTEES

10.5.1 Overseas Construction Projects

Guarantees are issued by the EXIM bank on behalf-of exports of turnkey projects and construction contracts, such guarantees include:

i. bid bond guarantee

ii. advance payment guarantee

iii. performance guarantee

iv. retention money guarantee and

v. guarantee for borrowing abroad.

Bid bond guarantee is issued for a maximum period of six months. For advance payment guarantee, exporters are expected to secure mobilization advance of 10-20 percent of contract value. Performance guarantee for 5 to 10 percent of contract is issued and is valid up to one year after completion of the contract. Guarantee for release of retention money enables the exporter to train the release of full payments.

Bridge finance, may be needed at the earlier phases of the contract. Up to 10 percent of the contract value may be raised in foreign currency, from a foreign bank against the EXIM bank's guarantee for borrowing abroad.

Check Your Progress

5 Bid bond guarantee is issued for a maximum period of _____.

Syndication of Export Credit Risks

EXIM bank and other banks participating in the funding of a loan would syndicate the respective credit risks to other eligible commercial banks, who would assume part of the total risk. Proposals valued at more than Rs.1 crore, entailing deferred credit exports of engineering goods and services, are forwarded by the sponsoring bank for consideration by an inter-institutional working group which meets at Mumbai, with EXIM bank as the focal point. While clearing the proposal, the participation arrangement for the funding of export credit is also determined.

Software Exports

The new policy of the government on computer software exports and development has rationalized the system of facilities and incentives for exports. Under the new policy, EXIM bank has been designated as an agency for facilitating speedy clearances and meeting foreign exchange requirements towards imports for computer software export where export obligation of 350 percent will undertake financial and technical analysis of Software export proposals and monitor the progress.

EXIM bank extends advisory services to exporters in several areas and undertakes promotional activities like techno-economic surveys collecting and disseminating market information.

EXIM bank offers an integrated package covering foreign currency and rupee term finance for acquisition of imported and indigenous computer/computer-based systems for export purposes.

EXIM bank welcomes the association of commercial banks for providing working capital finance for soffware export projects assisted by it

A rebate of 50 percent on customs duty payable on import of computer system is available to software exporters opting for 350 percent export obligation.

Export and Import transactions are governed by the EXIM policy" and the RBI exchange control regulations. While the EXIM policy regulates the movements of goods and services by prescribing the permissible exports and imports, the RBI regulations regulate the corresponding payments for these international transactions. While extending credit for any such trade, the banks need to make sure that the respective guidelines have been followed by the concerned parties. The RBJ regulations are given below:

10.5.2 Exchange Control Merchant Transactions

Exchange controls were introduced in India in 1939, during the World War II, to conserve foreign exchange, particularly the U.S. dollar, for meeting essential defence expenditure. The main purpose of exchange controls is to conserve foreign exchange and ensure its effective utilization.

After the World War II, the exchange control regulations framed under the Defence of India Rules were replaced by the Foreign Exchange Regulation Act, 1947, which was revised and replaced by title Foreign Exchange Regulation Act, 1973. With a view to create conductive climate for attracting foreign direct investment to increase production and promote exports. FERA 1973 has been substantially amended by FERA (Amendment) Act, 1993.

Exchange controls also cover foreign capital and activities financed by it. The administrative authority of foreign exchange regulation is vested with the Reserve Bank of India (RBI) and the routine work of exchange control is delegated to banks authorized

to deal in foreign exchange. Exchange controls and procedures are set out in the Exchange Control Manual published by the RBI.

10.5.3 Transactions Subject to Control

NOTES

a. Purchase, sale, and other dealings in foreign exchange and maintenance of balance at .foreign-centers.

b. Realization of export proceeds and payment for imports.

c. Payments to non-residents or to their accounts in India.

d. Transfer of securities between residents and non-residents and acquisition and holding of foreign securities.

e. Foreign travel 'with foreign exchange.

f. Export and import of currency, cheques, travelers cheques, securities, etc.,

g. Activities in India of foreign nationals and branches of foreign firms and companies.

h. Foreign direct investment and portfolio investment in India including investment by non- resident Indians, persons of Indian origin and corporate bodies predominantly owned such persons

i. Appointment of non-residents and foreign nationals and foreign companies, etc. as agents in India.

j. Setting up of joint ventures/subsidiaries outside India by Indian companies;

k. Acquisition, holding and disposal of immovable property in India by foreign nationals.

l. Acquisition, holding and' disposal of immovable property outside India by residents in India.

Check Your Progress

6 Exchange controls were introduced in India in the year_____.

10.5.4 Permitted Currency

Exchange Control has set out regulations governing permitted currencies and methods of payment to be used for settlement of financial transactions between residents and non-residents,, through authorized dealers.

„Permitted currency", as per the Exchange Control Manual is a foreign currency which is freely convertible, i.e., a currency which is permitted by the rules and regulations of a country concerned to be converted into major reserves currencies like U.S. Dollar, Pound Sterling and for which a fairly active market exists for dealing against the major currencies.

Authorized dealers should receive remittances from foreign countries (other than Nepal and Bhutan) or obtain reimbursement from their branches and correspondents in those countries against payments due for exports from India and other payments in a manner conforming to the methods of payment indicated below:

Group	***Permitted Methods***
i. All countries other those listed in (ii) bellow	a. Payment in rupees from the account of a bank situated in any country in the Group b. Payment in any permitted currency.
ii. Member countries in the Asian clearing union (except Nepal), Bangladesh, Myanmar, Islamic Republic of Iran, Pakistan, Sri Lanka	a. Payment for all eligible current transactions in Indian rupees of Asian Monetary Unit (AMU) or in the currency of the participating country in resident. b. Payment in any permitted currency in other cases

Note:

In respect of exports, payment must be received in a currency appropriate to the country of final place of destination of the goods as declared of GR forms, etc. irrespective of the country of residence of the buyer.

10.5.5 Exports

Every person/firm/company engaged in export business in India should obtain importer exporter code number from Director General of Foreign Trade (DGFT) as required in trade policy. Export of goods is the most important foreign exchange earning activity for the country. The physical export of commodities is regulated by the offices of Director General of Foreign Trade who may prohibit the export of certain commodities, stipulate that certain commodities be subject to license, prescribe minimum export price. Export of certain commodities might also be regulated by other statutes. The items eligible for exports (imports) are announced through Export Import Policy for an export is also regulated by FERA, 1973.

Declaration of Export Value

Under the Exchange Controls, it is obligatory for an exporter to declare the full export value of the goods or the value he expects to receive for the sale of the goods to any place outside India other than Nepal and Bhutan. The forms in which declaration of exports to various destinations has to made are prescribed by the Reserve Bank of India.*

The following forms have been provided for declaration of export value *by* the FERA Rules, 1973:

a. For exports to all countries made otherwise than post. GR Form

b. Exports to all countries by parcel post, except when made on „value payable or" cash on delivery basis". PP From

c. Exports to all countries by parcel post on „value payable" or cash delivery basis. VP/COD Form

GR forms in duplicate should be submitted to the Collector of Customs, who after due verification and authentication forwards the original form to the RBI and the duplicate to the exporter, to be submitted to the authorized dealer. PP forms in duplicate should be submitted to the authorized dealer who countersigns the forms

and forms and forwards the original to the exporter to be handed over to the postal authorities. After the dispatch of the goods, the postal authorities forward the form to RBI.

On realization of export proceeds, after due certification, the authorized dealer submits the GR/PP forms to the RBI.

VP/COD should be submitted to the postal authority which will forward it to the RBI.

Exemptions

Some categories of exports are exempted from declarations on prescribed forms. They are as follows:

1. Trade samples supplied free of payment.
2. Personal effects of travelers, whether accompanied or unaccompanied.
3. Ships' stores, transshipment cargo and goods shipped on orders of the Central Government or the military, naval,-air force authorities in India.
4. Goods for which RBI has waived such declaration.
5. Goods dispatched by air freight where sender declares that they are less than Rs. 10,000 in value, and that their dispatch does not involve any transaction in foreign exchange.

10.5.6 Payments

Full proceeds of payment for exports of goods from India-must- be realized on the due that for payment or within six months from the date of shipment of the goods whichever is earlier. However, if the goods are exported to a warehouse outside India/the period will be 15 months. The period of 6 months of 15 months as the case may be, may be extended by BBI, if sufficient and reasonable cause is shown.

Payment for exports from India must be realized by approved methods of payment.

10.5.7 Consignment Exports

Where exports are made on consignment basis, the exporter continues to be the owner of the goods until they are sold in the overseas market. The foreign consignee in such a case acts as the agents of the exporter for selling the goods. When the goods are sold, the consignee furnishes to the exporter an „account sale' giving details of the sale proceeds realized and the various expenses incurred and remits the net proceeds to the exporter after adjusting his commission. In such cases, the authorized dealer should instruct the collecting bank/branch that .the documents should be delivered only against a trust receipt/undertaking to deliver the sale proceeds within the period prescribed for the realization of the export proceeds.

In view of the situation prevailing in the CIS countries (former USSR) and East European Countries (formerly parts of COMECON) and with a view to supporting the revival and growth of India's exports to those countries it has been decided, in consolation with the Government of India, to allow, in deserving cases and on application by the individual exporter with a satisfactory track record, a longer period of up to 12 months for realization of proceeds for exports on consignment basis to these countries. Accordingly, it would be necessary for the individual exporters desirous of exporting goods to these countries on consignment basis, on credit terms extending beyond six months, to apply to Reserve Bank for permission for realization of export proceeds beyond six months even before the shipments are made.

10.5.8 Imports

Every importer has to obtain importer exporter code number .from DFGT.

Payment for import of goods into India constitutes the major part of outgo of foreign exchange. Import of any type of goods is also regulated by the government through office of Director General of Foreign Trade.

Terms of payment to be made for imports are governed by FERA, 1973, coupled with Exchange Control Regulations.

Goods can be imported into India freely except to the extent such imports are regulated by the Negative List* of imports or any other law for the time bring in force.

10.5.8.1 Import Letters of Credit

Authorized dealers are permitted to open letters of credit (L/Cs) on behalf of their customers, subject to the normal banking procedures and other provisions. However, authorized dealers are not allowed to open letter of credit or remit for import of goods included in the restricted list unless the importer submits a license marked For Exchange Control Purposes".

Letters of Credit (L/Cs) can be opened by Authorized Dealers (AD?) against specific licenses or OGLs, only on behalf of their customers, who maintain accounts with them and are known to be participating in the trade. L/Cs should not be opened in favor of importer himself or his nominee. Without RBI's approval, L/Cs should also not be opened in favor of overseas buying agents of importers. L/Cs should not be opened by ADs against guarantees offered or margins deposited by third parties.

Before opening L/Cs, the underlying sales contract in original should be verified. In the absence of sale contract, ADs may accept any of the under noted documents:

1. Order together with the confirmation of overseas supplier.
2. Pro forma invoice of overseas supplier duly countersigned by importer.
3. Indent/offer from overseas supplier or his agent.

L/Cs must provide for payment against delivery of shipping documents.

Opening of revolving letters of credit should as far as possible be avoided. However, in exceptional cases they may be opened with adequate safeguards/conditions subject to trade controls, particularly with reference to aggregate drawings under L/Cs and shipment dates.

The CIF value of the import licenses does not include premium for war risk insurance. L/Cs can therefore, be opened for the CIF value of the license, plus any amount required to meet the cost of war risk premium.

A statement to this effect must be made by the AD on Form AT, to be forwarded to RBI covering the remittance.

ADs' may make remittances in excess of CIF value of the import license where the excess payment is solely on account of:

i. increase in freight charges, bunker's surcharges or congestion surcharges at foreign ports, subsequent to the placement of firm orders by importers.

ii. adverse fluctuations in the exchange rate taking place after irrevocable letters of credit were opened or, if no L/C was opened after shipment has been made.

iii. when there is already a shortfall in the license in spite of (ii) above, ADs. may make remittance.

10.5.9 Advance Remittances

Advance remittances against goods to be imported into India are permitted. However, in case import of capital goods, it is restricted to 15% of the value. In addition to the above ceiling, advance remittances are allowed subject to the following conditions :

i. Order placed by the importer and demand by the overseas supplier for advance payments are to be verified.

ii. Remittance should be made direct to the suppliers.

iii. The importer should hold the EC copy of a valid importer license, if the goods to be imported are those included in, the negative lists of imports given in the EXIM policy.

iv. Guarantee from an international bank of repute situated outside India should be obtained, if the amount of advance exceeds US$ 15,000.

v. Physical import of goods should be made within 3 months (12 months in case of capital goods) from the date of remittance.

vi. Evidence regarding the terms of payment to the supplier, in case of import of capital goods should be submitted.

vii. List of books to be imported, in case of import of books, should be obtained.

10.5.10 Payment for Imports

Payments in retirement of import bills, either under letter of credit or on collection basis should received by debit to the account of the importer with the authorized dealer or by means of crossed cheque drawn by him on his other bankers. Payments against bills should not be accepted in cash- en in the case of private imports, if the amount involved is Rs. 20,000 or more, the above procedure to be followed.

The payments for imports into India must be made within six months from the date of shipment the case of "cash" licenses. In case, settlement is delayed on account of disputes, financial difficulties etc., remittances can be made even after the period of six months, provided:

i. Authorized dealer is satisfied about bonafide circumstances leading to delay in payment.

ii. no payment of interest is involved for the delayed period.

In the case of import documents negotiated under letters of credit, if reimbursement was given to overseas bank within six months from the date of shipment, even if the documents are retired by the importer after expiry of six months, the payment is in order. However, all cases of extended payments require RBI's approval.

10.5.10.1 Attestation of Invoices

Under customs regulations, importers have to submit to the customs authorities at the time of clearance of goods, a copy of the invoice attested by the AD through whom remittance has been/will be made, as corroboratory evidence of the value of the goods declared in the Customs Bill of Entry.

10.6 SUMMARY

Generally, ADs can freely make remittances against documentary bills received for collection in respect of imports by sea of air freight. In respect of clean bills, either the importer must produce "Exchange Control", copy of Customs Bill of Entry, or if goods have not arrived, he must produce documentary evidence that the goods for which remittance is required to be made have been shipped. The imports must, of course, comply with trade control regulations.

10.7 KEY WORDS USED IN THE LESSON

Letters of credit

EXIM Bank

Exchange control

10.9 Answers to check your progress questions

1 Revocable Letter of Credit

2 Countervailing credit

3 Extended packing credit

4 Turnkey

5 Six months

6 1939

10.10 MODEL QUESTIONS

Short-Answer Questions

1. Define Letter of Credit.
2. Who are the parties involved in Letter of credit?
3. What is Pre-Shipment Credit?
4. What are the factors considered in Turnkey Project?
5. What is meant by forfaiting?
6. What are the relending facilities offered by EXIM Bank?
7. Write short notes on :

   (a) Permitted Currency

   (b) Guarantees

   (c) Advance against incentives

Essay Questions

1. Bring out the various types of letters of credit in Import Financing.
2. Discuss the role of EXIM Bank in Trade Finance.
3. What are the various transactions covered under Exchange Control Act, 1939?

10.8 Further reading

International Trade and Export Manageent – Dr.Francis Cherunilam, Himalaya Publishing House

A Text book of Foreign Trade and Foreign Exchange by B.K.Chaudhuri and O.P.Agarwal, Himalaya Publishing House

Finance of Foreign Trade and Foreign Exchange by B.K.Chaudhuri, Himalaya Publishing House

Model Questions

Time: Three hours maximum: 100 marks

Answer any FIVE questions. All questions carry equal marks.

1. How are exchange rates between different currencies determined under the paper currency standard?
2. What are the main constituents of a' country's balance of Payments? Illustrate your answer with Indian example.
3. Explain the fundamental of a contract of Marine Cargo Insurance.
4. How do the functions of the IMF differ from those of the World Bank?
5. How the ECGC helps the exporters in obtaining finance?
6. Distinguish between consular invoice and commercial invoice.
7. State the particulars and explain the significance of any five documents used in export trade.
8. Explain the objectives of exchange control.
9. Briefly explain the various forms of incentives available for export trade.
10. Write short notes on :

    (a) Revaluation

    (b) Devaluation

    (c) Advance against incentives

Model Questions

Time: Three hours maximum: 100 marks

Answer any FIVE questions. All questions carry equal marks.

1. What are the different types of payment of international trade? Explain.
2. Describe briefly the meaning of balance of payments. Suggest for correcting an adverse balance of payment.
3. Explain the various types of trade barriers in international trade.
4. Briefly discuss about the various determinants of Exchange Rates.
5. Give a brief account of Exchange Control Manual.
6. Explain briefly the meaning of SDR. How it is going to be used?
7. Explain the functions and role of EX1M Bank.
8. Describe the various phases of Export trade.
9. Write the impact of FDI in International Trade.
10. Write shorts on any Two of the following :

    (i) Consular Invoice

    (ii) Documentation

    (iii) ADB

Model Questions

Time: Three hours maximum: 100 marks

Answer any FIVE questions. All questions carry equal marks.

1. Briefly explain different types of bill of exchange used in foreign trade.
2. Explain the significance of documentation in international trade.
3. Write about FEDAI and importance in international trade.
4. Describe briefly the role of ECGC in the export promotion of India.
5. Explain the problems and prospects of 100% Export Oriented Units in the liberalized Indian Economy.
6. Write the various Credit facilities available for Indian exporter from Commercial Banks.
7. Explain the significance of EXIM Bank.
8. What do you understand by foreign exchange? How is foreign exchange earned by a country?
9. Outline the impact provisions of FEMA.
10. Write a short notes on any Two Questions :

    (i) Advance against incentives

    (ii) Quota

    (i) Anti-dumping

PREVIOUS YEARS UNIVERSITY QUESTION PAPERS

M.B.A, DEGREE EXAMINATION, APRIL 1998

FINANCE OF FOREIGN TRADE AND DOCUMENTATION

(For those who joined in July 1993 and after)

Time: Three hours Maximum: 100 marks

Answer any FIVE questions. All questions carry equal marks.

1. Briefly explain the different contract terms used in foreign trade.
2. State any four shipping documents and explain their significance.
3. Explain the significance of EXIM scripts.
4. Discuss the mechanics of various exchange rates.
5. Give a brief account of Exchange Control Manual.
6. Explain the problems and prospects of 100% export oriented units in the liberalized Economy.
7. Bring out the merits and limitations of Partial and full convertibility of rupee.
8. Discuss the role and function of International Monetary Fund.
9. Briefly explain the various the various forms of incentives available in India for export trade.
10. Write short notes on :

    (a) Pre-shipment and Post-shipment credit.

    (b) Spot and Forward rates

    (c) Devaluation and Revaluation

M.B.A. DEGREE EXAMINATION, APRIL 1999

FINANCE OF FOREIGN TRADE AND DOCUMENTATION

(For those who joined In July 1997 or earlier)

Time: Three hours Maximum: 100 marks

Answer any FIVE questions. All questions carry equal marks.

1. Explain briefly the meaning of balance payments. What methods would you suggest for correcting an adverse balance of payments?
2. What is meant by full set of shipping documents? Briefly explain the significance of each of them.
3. In what way can authorize dealers and exporters in India cover exchange rate?
4. Describe briefly the role of the E.C.G.E; in the export promotion of India.
5. What do you understand by Foreign exchange? How is foreign exchange earned by a country?
6. Discuss the functions and role of EXIM Bank.
7. Explain the basis of exchange rate quotations for pound sterling and other currencies by the authorized dealers for merchant transactions.
8. Distinguish between Gold Standard and Special Drawing Rights.
9. Outline the import provisions of Foreign Exchange Regulation Act (FERA).
10. Write short notes on any TWO of the following:

    (a) Terms of Trade

    (b) Marine Insurance Risks

    (c) Deferred Payment Exports.